Final Department of Labor Fiduciary Rule's Effects Are Substantial

Our updated estimates of the impact on the financial sector and industry.

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Executive Summary

The U.S. Department of Labor has released its finalized conflict-of-interest, or fiduciary standard, rule for financial advisors, and we believe that it will disrupt many business models in the industry. We've already seen the exit of several foreign banks (Barclays, Credit Suisse, Deutsche Bank) from the U.S. wealth management landscape, sale of life insurance retail advisory businesses (AIG, MetLife), and restructuring of wealth management platforms (LPL Financial, RCS Capital, Waddell & Reed) in anticipation of the rule. We agree that the Department of Labor's finalized rule is in many ways more lenient than the initial proposal, especially in terms of the operational feasibility of the best-interest contract exemption. That said, a couple of areas of the rule were made even more restrictive, and the rule still has teeth through the best-interest contract as a litigation-based enforcement mechanism. In fact, we foresee that compliance with some of the rule's provisions may not only cause changes in how financial advisors service retirement accounts, but also how they serve taxable accounts.

Key Takeaways

- After updating our analysis from our Financial Services Observer "The U.S. Department of Labor's Fiduciary Rule for Advisors Could Reshape the Financial Sector" with more recent information, we still believe that the rule affects approximately $3 trillion of full-service wealth management client assets, that there's about $19 billion of wealth management revenue related to these assets, that operating margins on wealth management IRAs will contract several percentage points, and that in excess of $250 billion of full-service wealth management assets will move to a different investment service offering.
- Three key financial sector trends—a move to fee-based accounts, adoption of robo-advisors, and a shift to passive investment products—continued in 2015 and will accelerate because of the rule.
- Over $4 trillion of defined-contribution plan assets being offered advice and more than $800 billion of defined-contribution plan assets receiving a form of advice need to be checked against compliance with the fiduciary rule.
- Upwards of $200 billion of annual IRA rollovers will likely fall under the rule. Wealth management firms will have to substantiate why a rollover will be in an investor's best interest or risk reductions in asset inflows. Retirement plan providers will benefit from keeping more assets on their platform.
- Changing financial product allocations among broker-dealer advisors will reasonably lead to an over $140 billion increase in exchange-traded fund assets.
- We believe that fiduciary rule beneficiaries TD Ameritrade and London Stock Exchange are currently attractively priced and that any negative effects of the rule on Stifel Financial and Morgan Stanley are also already well priced into the shares. Those with a more bearish view on the economy can consider Charles Schwab or a pair trade of Raymond James Financial with Stifel Financial or Morgan Stanley.

Companies Mentioned

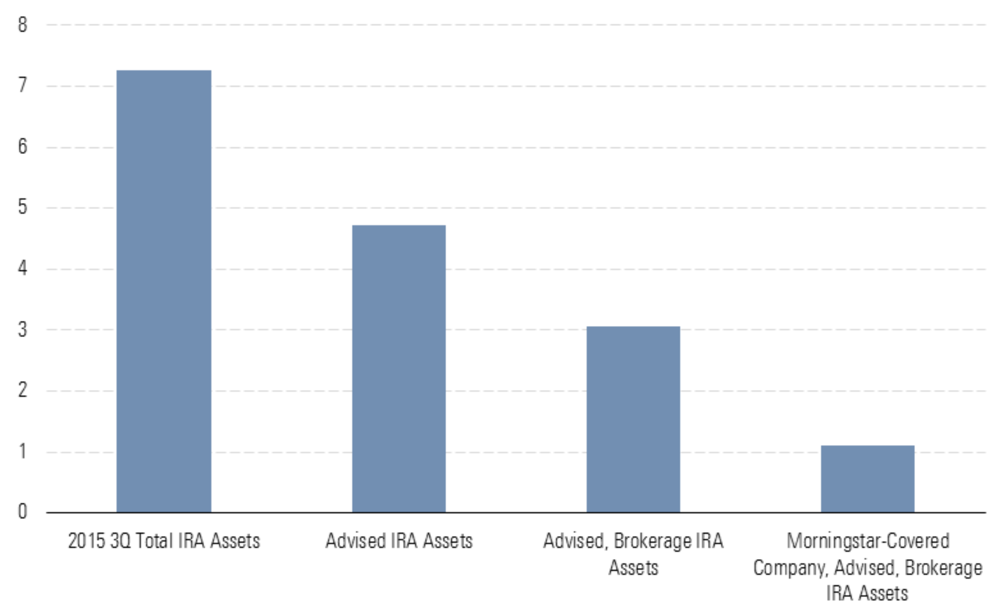
Name/Ticker	Economic Moat	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Credit Rating	Market Cap (Bil)
Bank of America BAC	Narrow	Stable	USD	17.00	13.93	High	★★★★	BBB	143.09
Charles Schwab SCHW	Wide	Stable	USD	30.00	27.69	High	★★★	A+	36.60
London Stock Exchange LSE	Narrow	Stable	GBX	3,100.00	2,593.00	Medium	★★★★	—	9.04
Morgan Stanley MS	Narrow	Stable	USD	36.00	26.21	High	★★★★	BBB	50.77
Raymond James RJF	None	Stable	USD	58.00	50.77	High	★★★	—	7.19
Stifel Financial SF	None	Stable	USD	49.00	33.87	High	★★★★	—	2.25
TD Ameritrade AMTD	Narrow	Stable	USD	39.00	28.95	High	★★★★	A	15.31
Wells Fargo WFC	Wide	Stable	USD	61.00	48.27	Medium	★★★★	A	245.07

The Finalized Department of Labor Fiduciary Rule Is Seen as More Lenient, but Our Estimates of Its Effect on the Financial Sector Remain Substantial

After digesting the finalized Department of Labor's fiduciary rule and incorporating updated information, we still assess that the rule will reshape the financial sector. Through its ability to influence the policies and procedures of wealth management firms and the behavior of financial advisors to many tax-qualified accountholders, the entire value chain from financial product manufacturers to financial product distributors and investors has to be reconceived.

Our primary estimate of the assets that will be subject to a new fiduciary duty remains $3 trillion of advised, commission-based brokerage IRA assets.

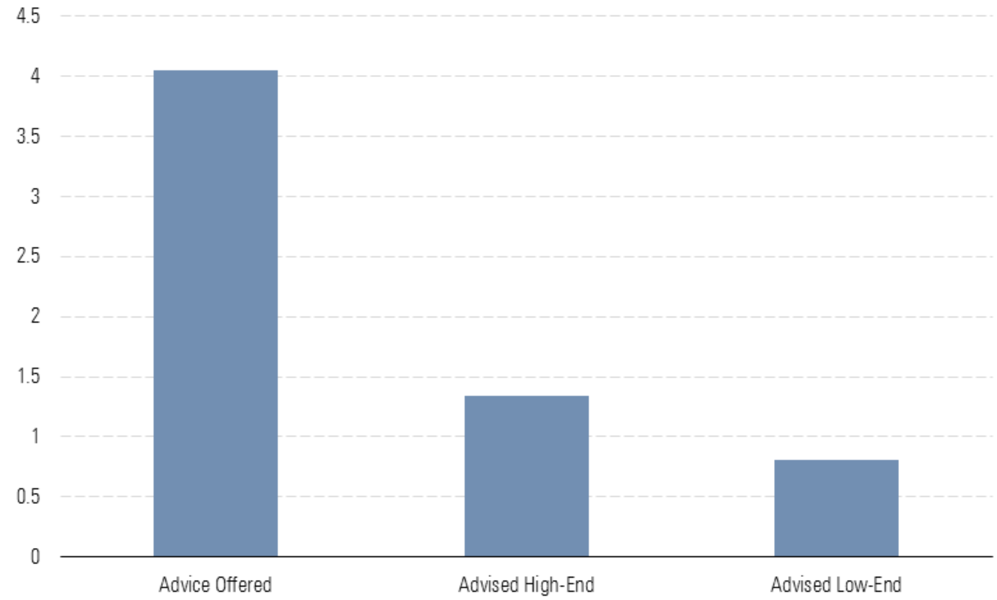
Exhibit 1 We Estimate That Around $3 Trillion of Client Assets Will Be Affected by the Department of Labor's Rule and That Publicly Traded Wealth Management Firms Hold Over $1 Trillion ($ Trillions)



Source: Company filings, U.S. Federal Reserve, Morningstar

In addition to the $3 trillion of advised, commission-based IRA assets, we estimate that advice services are being offered to approximately $4 trillion of private, defined-contribution-plan-participant assets and that there's upwards of $800 billion of plan assets that are using advice and could be subject to the rule. Advice providers to private defined-contribution plan participants need to double-check that how they formerly advised or managed assets on behalf of retirement plan participants remains in line with the Department of Labor's updated rules.

Exhibit 2 Advice Being Offered to Over $4 Trillion of Private Defined-Contribution Assets and Used By Upwards of $800 Billion Needs to Be Checked For Compliance With the Fiduciary Rule ($ Trillions)

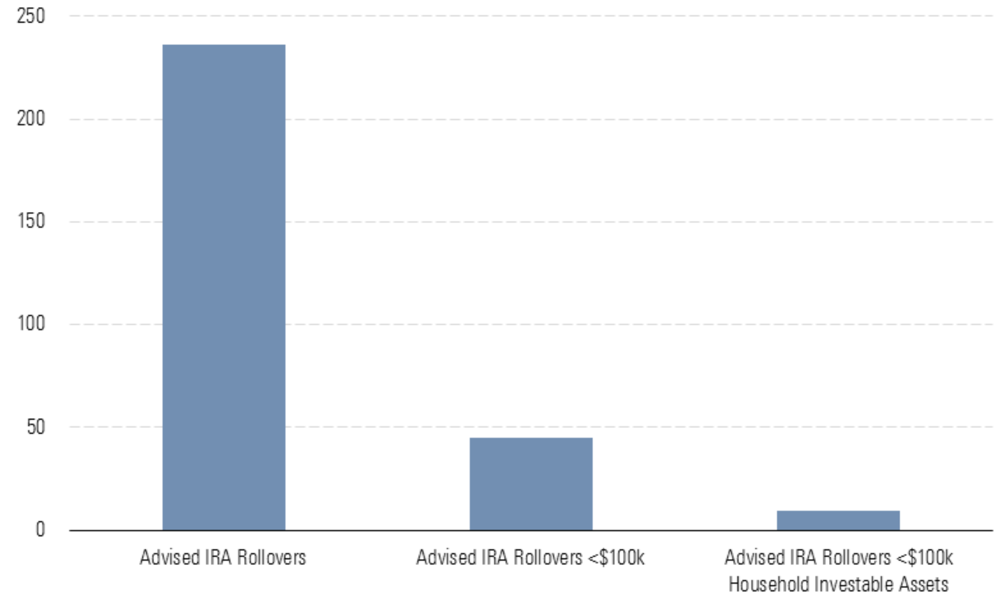


Source: Mercer, Morningstar, Oliver Wyman, Plansponsor Magazine, U.S. Federal Reserve

The finalized rule, as in the initial proposal, classifies advice on rollovers from an employer-sponsored plan to an IRA as fiduciary advice. Besides broker-dealer advisors that have to comply with the full best-interest contract, even level-fee Registered Investment Advisers have to comply with the streamlined best-interest contract that requires acknowledging fiduciary status and documenting why the rollover is in the best interest of the client. The documentation must take into account the difference in fees and services between the employer-sponsored plan and the IRA. Because of the increased compliance procedures and potential difficulty in justifying a rollover, it's reasonable to believe that more assets will stay in employer-sponsored plans like 401(k)s.

Assets staying in 401(k) plans will benefit retirement plan platform providers, while reducing net inflows into wealth management firms. According to the Investment Company Institute, 63% of households with traditional IRAs used a professional financial advisor as a source of information when making their rollover decision. Translating this into dollar terms, we estimate that over $200 billion of annual rollover assets will be covered by the fiduciary rule. Looking at rollovers from the perspective of financial advisors that may decline to advise small-balance clients, we estimate that nearly $50 billion of IRA rollovers are for amounts less than $100,000 and that about $10 billion of IRA rollovers annually is from households that don't possess $100,000 of total investable assets.

Exhibit 3 Over $200 Billion of Annual IRA Rollovers Are Covered by the Rule, Which Can Reduce Inflows to Wealth Management Firms and Benefit Retirement Plan Platform Providers ($ Billions)



Source: Deloitte & Touche, Employee Benefit Research Institute, Investment Company Institute, Morningstar

The Department of Labor's updated cost estimates for implementing the rule are now even higher than initial estimates. It's arguable that the more explicit costs of implementing the rule should be lower than the Department of Labor's revised estimates, since the new estimates are based on the survey results received from the financial-services sector for the stricter, initial proposal. The Department of Labor modestly reduced the industry estimates to account for the new rule's slightly lower requirements, but we believe that the agency remained fairly conservative in estimating costs as a whole.

Exhibit 4 The Department of Labor's Updated Cost Estimates Are Even Higher Than the Financial Sector's Initially Provided Survey Results ($ Millions)

	Department of Labor	**Deloitte-SIFMA**		**Oxford Econ-FSI**
		DOL Methodology	Alternative Methodology	
1st Year Costs	4,822	2,200	4,700	3,870
Ongoing	1,404	563	1,100	

Source: Deloitte & Touche, Department of Labor, Oxford Economics

Based on the Department of Labor's cost estimates, the aggregate value of the affected firms would decrease by approximately $15 billion if the costs aren't mitigated or offset with additional revenue opportunities. The value impact on the sector can also be much greater or smaller than $15 billion based on an increase or decrease of the affected revenue, which we estimate at around $19 billion, or costs that haven't been quantified, such as penalties related to lost litigation. The $15 billion loss for the sector from explicit implementation expenses also understates the gross transfers of value that will occur from firms challenged by the rule, such as alternative asset managers and life insurance companies, to those advantaged by the rule, such as discount brokerages, financial technology companies, and passive investment management firms.

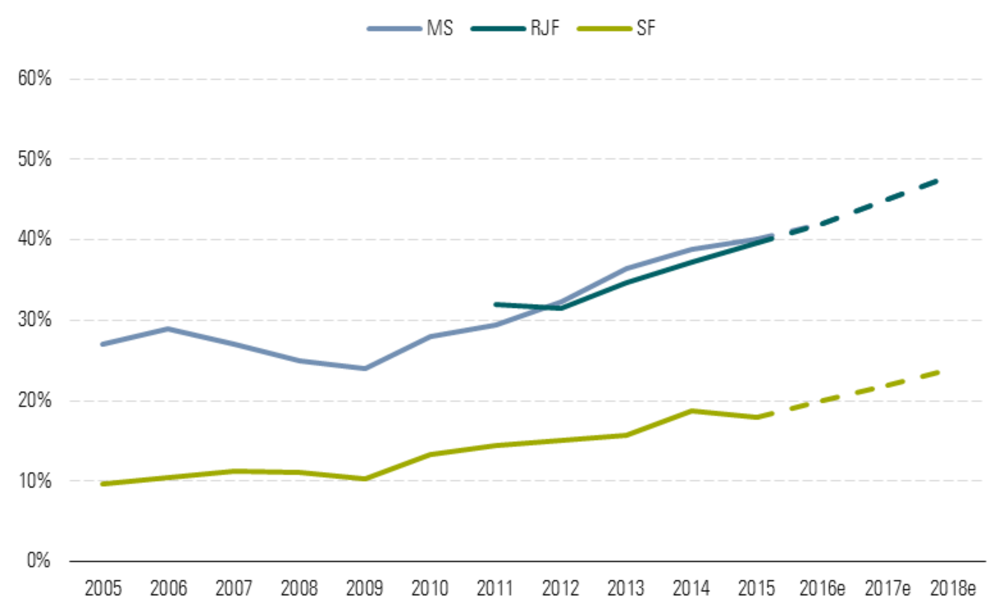
Finalized Fiduciary Rule Will Ensure Acceleration of Three Key Financial Sector Trends

We continue to believe that the fiduciary rule will accelerate three key financial sector trends:

- The movement to fee-based from commission-based full-service wealth management accounts.
- Adoption of robo-advisors and digital advice solutions.
- Shift to relatively lower-cost passive investment products from actively managed.

Through 2015, the movement to fee-based accounts from commission-based continued. Morgan Stanley's proportion of fee-based assets increased 1.3 percentage points, while Raymond James' increased 2.4 percentage points. Stifel Financial's proportion actually decreased 0.7 percentage points, but this was likely due to the account mix of its 2015 Sterne Agee and Barclays' U.S. wealth management acquisitions.

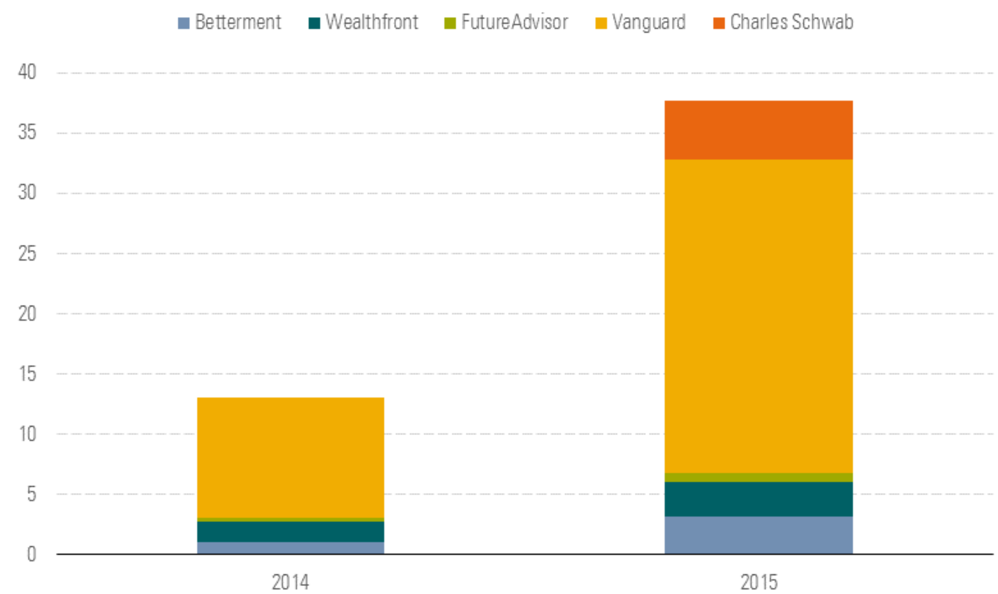
Exhibit 5 There Is a Trend Toward Fee-Based Accounts (Fee-Based Client Assets as a Percentage of Total Client Assets)



Source: Company filings, Morningstar

From 2014 to 2015, the client assets at several of the leading robo-advisors increased over 150%. We continue to believe that the stand-alone robo-advisors, like Wealthfront, are a logical landing place for clients with low account balances who may be unprofitable for full-service wealth management firms. Capturing just a fraction of the $250 billion to $600 billion of low-account-balance assets will accelerate their growth by several years and bring them closer to the $16 billion to $40 billion client asset breakeven point that we estimated in our April 2015 report "Hungry Robo-Advisors Are Eyeing Wealth Management Assets."

Exhibit 6 Leading Robo-Advisors More Than Doubled Their Assets in 2015 ($ Billions)

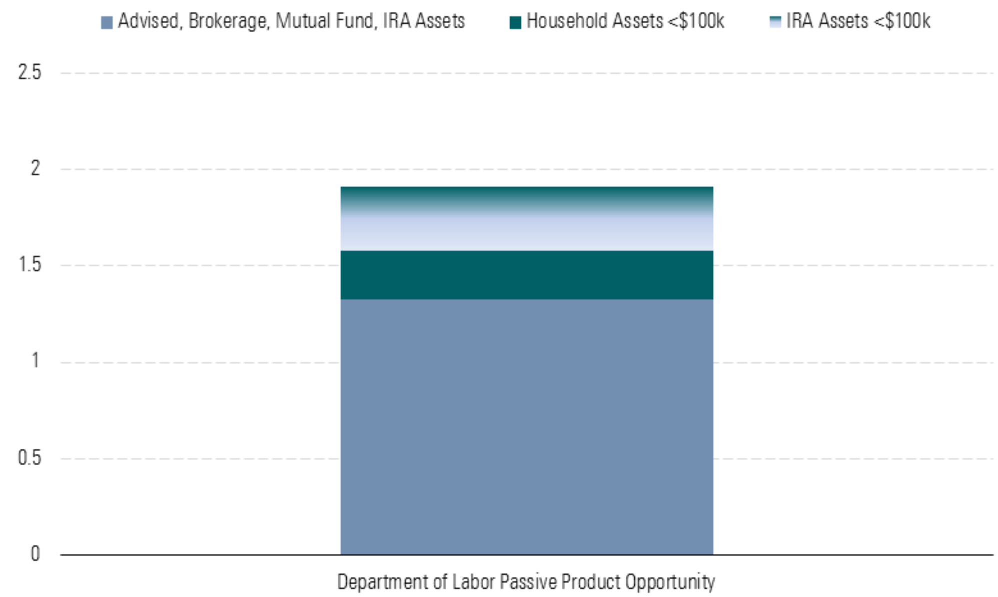


Source: Company comments, Company filings, Morningstar

While the fiduciary rule will be a needed boost to the robo-advisors that serve investors directly, it will be an even greater accelerant to robo-advisors or digital advice technology used by the established full-service wealth management firms. Digital advice companies that support wealth management firms should experience a more explosive growth rate than that experienced by the robo-advisors serving investors directly, as they can quickly leverage the advisor networks they tap. BlackRock's FutureAdvisor unit has already signed agreements with LPL Financial and Royal Bank of Canada since the beginning of 2016. The wirehouse wealth management firms are also exploring digital advice solutions. For firms that don't have core competencies in design, technology, and investing, partnering with an established robo-advisor makes economic sense.

We still put the potential shift to passive investment products after the rule at over $1 trillion from the amount of mutual fund assets held in affected IRAs and robo-advisor opportunity. While the streamlined high-quality, low-fee exemption wasn't included in the final rule, we continue to believe that passive investment share will accelerate from the reduction in potential conflicts of interest stemming from third-party payments, increased adoption of robo-advisors, and total-cost balancing. We also think that firms with previously more-closed architecture may add products like index-based target-date funds to supplement their limited product menu, as the Department of Labor specifically stated that "If another type of investment would be in the Retirement Investor's Best Interest, the Adviser may not, consistent with the Best Interest obligation, recommend a product from its limited menu." Index-based target-date funds should also benefit from more assets staying in defined-contribution plans from enhanced fiduciary rollover substantiation requirements.

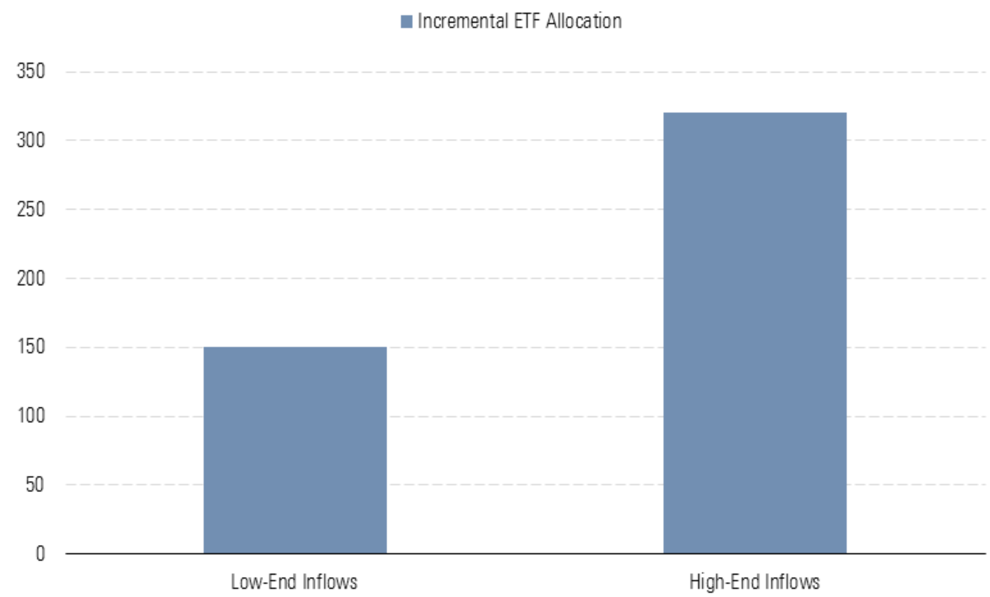
Exhibit 7 Passive Investments Could Gain Over $1 Trillion of Assets From the Fiduciary Rule ($ Trillions)



Source: Morningstar

Digging down into just the shift of assets into ETFs, not including passive index funds, we estimate a reasonable opportunity upwards of $140 billion based on the ETF product allocation difference between RIAs that are currently under a fiduciary standard and broker-dealer advisors under a suitability standard.

Exhibit 8 Broker-Dealer Advisors Moving to a Fiduciary Standard May Incrementally Allocate More Than $140 Billion of Assets to ETFs ($ Billions)



Source: Cerulli Associates, Morningstar

The Finalized Department of Labor Fiduciary Rule Is Full of Challenges and Opportunities

We continue to believe that the fiduciary rule will disrupt the financial-services sector and that there will be positive and negative effects on financial industries and firms. The revised rule includes some material changes, many that make it more lenient and some that make it more restrictive, but the overall view we expressed in our October 2015 Financial Services Observer "The U.S. Department of Labor's Fiduciary Rule for Advisors Could Reshape the Financial Sector" still holds. We believe that the beneficiaries will be discount brokerages, financial technology companies including robo-advisors, and and providers of passively managed products (primarily index funds and exchange-traded products like ETFs). There will be a mixed effect on active asset managers and full-service wealth management firms, while certain alternative asset managers and life insurance companies will be challenged.

Exhibit 9 The Fiduciary Rule Has Positive and Negative Repercussions Throughout the Financial Sector

	Pay/ Receive 3rd Party Payments	Client Asset Inflows/ Outflows	Expenses/ Legal Exposure	Vertical Integration Conflict	Moat-Based Market Share/ Mix Shift Gain	Overall
Fintech and Information/ Robos	Mixed/ Neutral	Positive	Positive	Mixed/ Neutral	Mixed/ Neutral	Positive
Discount Brokerages	Mixed/ Neutral	Positive	Mixed/ Neutral	Mixed/ Neutral	Mixed/ Neutral	Positive
Index and ETP Providers	Mixed/ Neutral	Positive	Mixed/ Neutral	Mixed/ Neutral	Mixed/ Neutral	Positive
Active Asset Managers	Negative	Negative	Mixed/ Neutral	Mixed/ Neutral	Positive	Mixed/ Neutral
Full-Service Wealth Management Firms	Negative	Negative	Negative	Negative	Positive	Mixed/ Neutral
Alternative Asset Managers	Negative	Negative	Mixed/ Neutral	Mixed/ Neutral	Mixed/ Neutral	Negative
Life Insurance Companies	Negative	Negative	Mixed/ Neutral	Negative	Mixed/ Neutral	Negative

Positive | Mixed/ Neutral | Negative

Source: Morningstar

Updated Industry Outlooks From Initial Proposal to Final

- Financial technology and information providers, including robo-advisors: Betterment, BlackRock, Charles Schwab, Envestnet, Financial Engines, Invesco, Morningstar, SEI Corporation, Wealthfront.
  We've added financial technology and information providers, including robo-advisors, to our chart of financial industries that we believe will benefit from the rule because of expenses/legal exposure and client asset inflows.

We see the financial technology and information companies as playing a key role in efficiently addressing some of the requirements of the rule and as a preventive measure for reducing legal liability risks. Given the increased compliance costs of the rule, wealth management firms will have an even greater incentive to streamline their workflows to offset these costs. Financial software providers that can help increase the productivity of financial advisors will become more ingrained and valued partners of wealth management firms.

The best-interest contract requires financial advisors to act prudently and receive only reasonable compensation. We believe that advisors and financial institutions will have to use more data and analytics to substantiate their best-interest obligations. Examples of best practices include benchmarking of financial product expenses to support reasonable compensation, benchmarking of plan expenses for rollovers, outside research to justify recommendations, and account aggregation capabilities to ensure that advisors using a limited menu of products don't imprudently overallocate, such as to proprietary alternative asset products. Savings in time and legal costs should more than substantiate taking these additional measures.

Scalable advice and investment management enabled by technology will be in higher demand. Firms and advisors may find it especially effective to use a digital advice or investment management service to handle low-balance retirement accounts. This will allow advisors to focus more of their time on higher-balance taxable accounts and potentially move some fiduciary responsibilities and compliance burdens to outside parties. In the past several months, we've already seen partnership announcements between BlackRock's FutureAdvisor with LPL Financial and Royal Bank of Canada. Multiple full-service wealth management firms are also developing their own in-house digital advice solutions. Because the economics of robo-advisors can be challenging, it might make more sense for many firms to partner with an existing one rather than develop their own.

► Discount brokerages: Charles Schwab, TD Ameritrade.
We still believe that discount brokerages stand to benefit from the rule. However, the net benefit is likely to be lower with the final rule than the initial proposal because it isn't as onerous on the full-service wealth management industry, and we've already seen competitive adaptation from the full-service wealth management firms.

Our assessment that discount brokerages will benefit from the rule was based primarily on our estimate that full-service wealth management firms currently have $250 billion to $600 billion of client assets in small-balance IRA relationships that may become unprofitable after the fiduciary rule. While that estimate remains unchanged, wealth management firms have begun adopting solutions to address small-balance accounts. For example, LPL Financial lowered its account minimum in its Optimum Market Portfolios advisory platform to $10,000 from $15,000 and Morgan Stanley hired a chief digital officer for its wealth management business. To the extent that these full-service wealth management initiatives keep assets in-house, there will be less available for discount brokerages to pick up. That said, capturing just a fraction of the potential assets would be value-accretive to the discount brokerages.

On the operational front, the discount brokerages aren't fully immune from the rule and there are multiple issues that they will have to work through. For the do-it-yourself side of their businesses, we see primary issues being related to IRA rollover and general investment education that IRA investors might access from the firms, as the firms generally don't want education to cross the line of being considered a financial recommendation. For their RIA businesses, they'll likely have to add to their compliance and support systems. There are also areas that are more company-specific, such as if they employ branch advisors that fall under the fiduciary rule, usage of proprietary products, or any additional responsibilities of providing a retirement plan platform.

Based on current valuations, we believe that shares of narrow-moat TD Ameritrade are more attractive than those of wide-moat Charles Schwab. Assuming a base case of slow economic growth in the U.S. over the next two to three years, we believe that TD Ameritrade's shares will outperform Charles Schwab's. Both firms have the same dual primary value drivers of interest rates and client asset levels, but TD Ameritrade's unique relationship with Toronto Dominion Bank means that its interest-related earnings growth doesn't need substantial retained equity to support. This in turn translates into TD Ameritrade being able to increase dividends and repurchases in line with earnings growth and that the company's earnings are worth more on a discounted free cash flow basis compared with Charles

Schwab. The next short-term interest-rate increase by the Federal Reserve should also be a material positive for TD Ameritrade's earnings, as it's near its 25 basis points sharing cap on the floating insured deposit account agreement with Toronto Dominion Bank and will capture more of this next increase than the previous one.

For those with the bearish view that short-term U.S. interest rates will not move or increase only 25 basis points in the medium term or that the yield curve will be flat, Charles Schwab's wide-moat business model can still experience reasonable growth. An additional 25-basis-point increase in short-term rates should add about $130 million to the company's bottom line from the reversal of money market fund fee waivers, an approximately 8% increase in earnings per diluted share. Over the next several years, gradually shifting client cash from money market funds where the maximum revenue yield is about 60 basis points into the company's bank where the net interest margin is closer to 175 basis points is also an avenue of earnings growth that is largely under the company's control. The shifting of money market fund assets could add upwards of $700 million to the bottom line.

Exhibit 10 We See TD Ameritrade As Currently More Undervalued Than Charles Schwab

Ticker	Moat	Price to FVE	Price to 2017 Earnings	Short Term Rates Leverage	Trading %	Asset Management %	Rate Related Revenue %	Adjusted ROIC
AMTD	Narrow	0.74	16.34	~45%	40%	10%	50%	30%
SCHW	Wide	0.92	17.99	~60%	15%	30%	55%	13%

Source: Company filings, Morningstar

- Index and exchange-traded product providers: BlackRock, Charles Schwab, London Stock Exchange, MSCI, State Street, Vanguard.
  Index and exchange-traded product providers are already benefitting from the secular trend to lower-cost passive investment products, but the shift will accelerate after the fiduciary rule for five reasons:
    - Reduction in potential conflicts of interest stemming from third-party payments.
    - Increased adoption of robo-advisors and digital advisory services.
    - Total-cost balancing.
    - Inclusion in platforms with previously more-closed architecture.
    - Usage of index-based target date funds in defined-contribution plans that will retain more assets.

We still believe that the acceleration will occur, but it won't be as much of a spike as it would have been if the streamlined high-quality, low-fee exemption proposal was included in the final rule.

We estimate that the total market opportunity is in excess of $1 trillion in assets and that a reasonable estimate of the additional ETF allocation from broker-dealer advisors moving to a fiduciary standard is upwards of $140 billion. High incremental margins on passive investment products and index licensing can translate into noticeable bottom-line growth for well-positioned firms. Because we believe that robo-advisors will benefit from the rule and that robo-advisors are a major emerging distribution channel for financial products, firms with direct ties to a robo-advisor, such as BlackRock and Charles Schwab, are competitively advantaged compared with nonvertically integrated peers. Please see our report "Hungry Robo-Advisors Are Eyeing Wealth Management Assets" for our view of the economics of vertically integrated robo-advisors compared with stand-alones.

We currently believe that London Stock Exchange Group, which has a merger agreement with Deutsche Boerse, is one of the better-priced companies exposed to the increased adoption of index products. Its information-services segment that contains the FTSE Russell indexes business comprises over one third of total revenue. On a stand-alone basis, we believe that the company is 15% undervalued, while a merger with Deutsche Boerse would make shares 20% undervalued.

Exhibit 11 London Stock Exchange With Its FTSE Russell Indexes Business Is 15% Undervalued on a Stand-Alone Basis and 20% Undervalued Assuming a Completed Merger With Deutsche Boerse

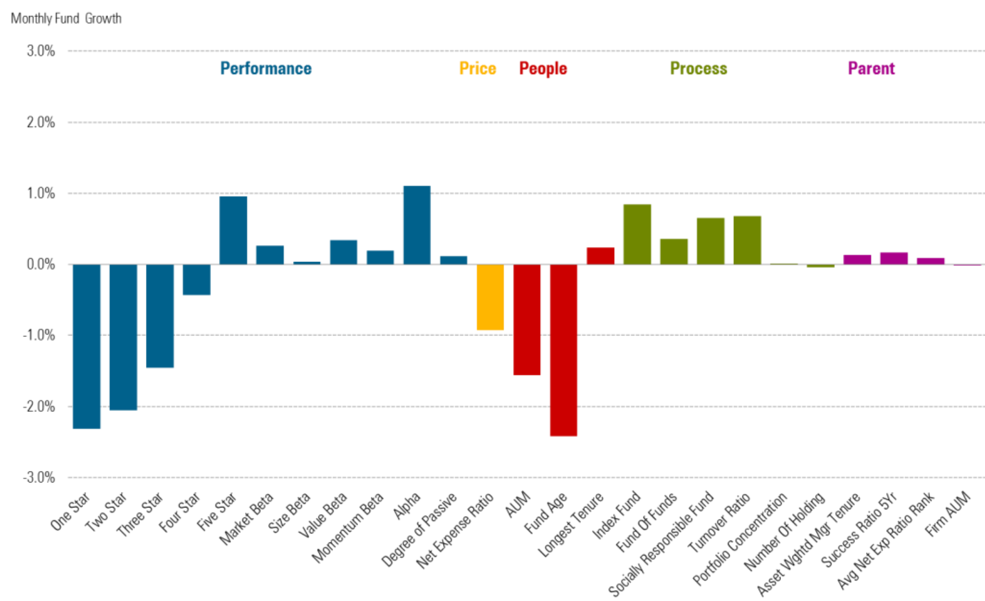
Ticker	Moat	Price to FVE	Price to 2017 Earnings	Indexes Segment Contribution	Adjusted ROIC
LSE	Narrow	0.84	21.1	33%	35%

Source: Company filings, Morningstar

- Active asset managers: AllianceBernstein, BlackRock, Cohen & Steers, Eaton Vance, Federated Investors, Franklin Resources, Invesco, Janus Capital Group, Legg Mason, T.Rowe Price Group, Waddell & Reed Financial.
  While the effect of the fiduciary rule on active asset managers is less direct than its effect on full-service wealth management firms, it could still be significant. On the operational side, it's likely that payment structures such as revenue-sharing agreements and 12b-1 fees will need to be reworked and that the number of share classes will need to be adjusted based on how the wealth management industry adapts to the rule. Active asset managers with vertically integrated wealth management businesses, or a direct business with call center employees who interact with retirement investors, are likely to be more directly affected by the rule.

  We expect the larger established active asset managers with higher-quality product, and niche managers with top-tier investment performance, to be more likely to gain market share from their disadvantaged peers as a result of the new rule. As Morningstar's Lee Davidson and Timothy Strauts examined in their November 2015 research paper "What Factors Drive Investment Flows," which relied on multifactor regressions to determine what attributes correlated with higher fund flows, individual funds and asset-management firms that score well in terms of Morningstar's Fund and Medalist Ratings (which are informed by the five pillars of Process, Performance, People, Parent, and Price) have tended to exhibit higher net inflows.

Exhibit 12 Morningstar Manager Research Medalist Rating Criteria Have Generally Expected Relationship to Fund Flows (% Monthly Fund Flow Growth Difference for Equity Funds With a One Standard Deviation Move From the Average)



Source: Morningstar Research

*certain factors are expected to show a negative correlation with inflows, such as an above average net expense ratio leading to a decrease in inflows

We also expect some of the other characteristics that serve as the foundation of asset manager economic moats—such as product mix, distribution channel relationships, and brand and reputation—to shift the balance to certain active managers at the expense of others. We believe that rating well on some of these factors will become increasingly important as payments for distribution are curtailed.

Broadly speaking, there are certain business mixes or product characteristics that will lead to more challenges or opportunities for the active asset managers. In terms of distribution channel, those that distribute more heavily through the full-service wealth management channel as opposed to the self-directed or institutional channels, or those that do a lot of subadvisory business for variable annuities, will face more headwinds. High-fee, low-performing funds will also be much harder to justify under a best-interest obligation. With robo-advisors, outsourced fiduciaries, and defined-contribution platforms all expected to benefit from the implementation of the rule, we expect a greater focus on top-performing funds, relatively low-cost funds, products that can work well within fee-based advice arrangements, and funds that fill a distinct role from a portfolio perspective.

Exhibit 13 The Fiduciary Rule Will Favor Certain Active Asset Management Distribution Channels and Products

Unfavorable		**Favorable**	
Channel	Product	Channel	Product
Advisor	High-fee	Defined Contribution Plan	High Performance
Variable Annuities	Low Performance	Outsourced Fiduciary	Low Fee
		Robo-advisor	Fee-based Account
			Portfolio Completion

Source: Morningstar

- Full-service wealth management firms: Bank of America, Morgan Stanley, Raymond James Financial, Stifel Financial, UBS, Wells Fargo.

While the finalized Department of Labor fiduciary rule is in many ways more lenient than the initial proposal, it will still require that substantial changes be made to the financial sector, and full-service wealth management firms will be the most affected. In order for most wealth management firms and advisors to continue operating in any semblance of their current form, they will have to comply with the requirements of the best-interest contract exemption, or BICE, to receive prohibited direct or indirect compensation, such as securities commissions, 12b-1 fees, and revenue sharing. The BICE relies on an actual contract that states that the financial institution has a duty to act in the best interest of its clients. As with any contract, its breach opens up the financial institution to legal claims. It is this potential for litigation that is the enforcement mechanism and boogeyman of the fiduciary rule.

We believe that the fiduciary rule will affect taxable accounts in addition to tax-qualified accounts. The best-interest contract exemption is administratively feasible, but it will be a task to implement. Many firms will choose to apply the same policies and procedures to both tax-qualified and taxable accounts in order to not have two different sets of workflows and systems. Additionally, wealth management firms may treat both tax-qualified and taxable accountholders in accordance with the Department of Labor's fiduciary standard, so as not to in actuality or give the perception to clients of differing service levels.

Firms can run two separate systems, but it may require much work. In terms of compensation, the fairly typical ratcheted compensation schedule may have to be revised to not factor in tax-qualified account-related revenue. Compliance departments may also choose to create different lists of financial products that are more suitable for either taxable accounts or tax-qualified accounts.

RIAs are already under a fiduciary standard, but it's an SEC standard that isn't wholly congruent with the prohibited transaction-based structure of the Department of Labor's standard. The two more prominent areas where RIAs will have to be careful is with IRA rollovers and if they receive commissions or third-party payments as a hybrid advisor. There is a "level fee fiduciaries" streamlined BICE primarily for rollovers and RIAs. However, while the streamlined BICE does away with the actual contract, it still has the impartial conduct standards of the BICE and requires documentation justifying the move to the level-fee arrangement.

Investment banks with advisors will take an additional hit to their fixed-income business from a less-mentioned modification that came with the fiduciary rule package. An exemption for principal transactions was also released with the rule that is meant to allow the receipt of conflicted compensation mainly related to fixed-income securities. However, the finalized exemption cannot be used for securities underwritten by the advisor's financial institution and certain other securities that may be sold on a principal basis, such as asset-backed securities that aren't guaranteed by an agency. The Department of Labor delivered a jab to the chin of investment banks whose fixed-income businesses are already on the ropes from government regulations on capital and proprietary trading.

Because of the costs of implementation, we expect consolidation in the full-service wealth management industry. Barclays, Credit Suisse, Deutsche Bank, and MetLife all entered into agreements with other U.S. advisor forces. Spreading the fixed costs of the fiduciary rule over a larger headcount will reduce the operating margin compression on full-service, commission-based IRAs that we previously estimated at 4 to 6 percentage points. On the margin, we also believe that those considering being or are already hybrid advisors may choose to become fee-only RIAs, as they weigh the additional compliance costs compared with commissions.

We don't see the Department of Labor's fiduciary rule as uniformly negative for all full-service wealth management players and believe that some firms, particularly those with economic moats, will weather the rule better or even profit from less competitively advantaged peers. Firms may gain from industry consolidation in two ways. The first is through clients consolidating assets at their preferred wealth management firm. No firm has 100% wallet share of their clients, and potentially increasing account minimums will lead clients to bring more assets to a service provider to meet account requirements. The wealth management firms with strong customer relationships built on brands and unique services will be advantaged, such as Bank of America Merrill Lynch, Morgan Stanley, and UBS. The second form of consolidation is of firms. We believe that firms such as Raymond James Financial, Stifel Financial, and Wells Fargo that have both an employee and independent channel along with room to fill in geographic footprints are poised to be major consolidators.

There are also revenue and expense offsets to the fiduciary rule for wealth management firms. Fee-based accounts have upwards of a 60% higher revenue yield than commission-based accounts. While moving an IRA account from a commission-based to a fee-based arrangement will now require documentation regarding why that's in the best interest of the client, we expect that the fiduciary rule will accelerate this movement and offset some of the compliance costs. Digital advice solutions, process streamlining, outsourcing fiduciary responsibilities, and meaningful analysis justifying that transactions are in the best interest of clients can also increase productivity or reduce costs.

Our overall conclusion regarding full-service wealth management firms is that the Department of Labor's fiduciary rule will disrupt their business operations, advisors will have to substantiate that their actions are in the best interest of their clients, and advisors will, more than ever, have to justify their value to clients.

Of the full-service wealth management firms, we believe that Stifel Financial is the most undervalued. For those with a medium-term horizon, we see Stifel Financial as a growth stock whose earnings will be back on track after a couple of bumpy quarters. Investment banking revenue for the beginning of this year is shaping up to be fairly awful, as volatile capital markets have reduced underwriting and merger activity. Not only is revenue likely to decrease, Stifel's cost structure will be bloated by an extra $100 million of acquisition integration costs in the first half of the year. So even on an adjusted basis, near-term earnings are not going to be pretty.

However, once past this rough patch, Stifel's earnings growth should outpace peers. A primary reason its growth slowed over the past year was that Stifel purposely restrained its balance sheet to put off having to take the Dodd-Frank stress test for another year. Now that the company's balance sheet is over $10 billion, Stifel can go back to its acquisitive ways or reinvest in its bank. This has already started to play out, with the company announcing the acquisition of Eaton Partners and ISM Capital Management and increasing its bank assets nearly 60% in one quarter. Since the company is likely sitting on over $150 million of excess capital, it can continue to look for acquisitions, grow its balance sheet several billion dollars, or repurchase shares at what we believe is an attractive price. Rising interest rates and operating leverage also provide additional drivers of medium-term earnings outperformance. Over the next five years, we project non-GAAP operating income to grow at an 11% compound annual rate.

Morgan Stanley is also worth considering. It will be clear that the company can earn its cost of capital and that it should trade right around book value once it's approved to return excess capital. The company currently has a fully phased common equity Tier 1 ratio of over 14% compared with a 10% minimum plus regulatory buffers and a supplementary leverage ratio of about 6% compared with a 5% eventual requirement. Returning this excess capital will add around 1 percentage point to return on equity and should justify the company trading at book value. We view the Federal Reserve allowing any of the large banks to draw down their excess capital as being a positive catalyst for Morgan Stanley, as it signals a regulatory willingness to reverse the stockpiling of capital. For a look at how capital returns work with Morgan Stanley, please see our March 2014 report "Goldman Sachs' and Morgan Stanley's Capital Returns."

In terms of the fundamentals of Morgan Stanley's business, we see questions about its fixed-income business as largely a distraction and that its wealth management business is where value will be created going forward. Institutional fixed-income trading revenue has been less than 15% of net revenue over the past five years, and with recent cuts in headcount, it will be even lower going forward. Whether returns on capital from fixed-income trading improve from top-line growth or reducing investment in the business, we don't see it as a material value creator or destroyer of the firm. The wealth management business and related net interest income is where earnings growth will come from. We project net interest income growing 67% to about $5 billion over the next several years, which would increase 2015 pro forma earnings per share nearly 20%. For our view on secular and cyclical factors in credit trading, please see our June 2013 report "Who Is Affected by Changes in the Credit Trading Environment?" For a more detailed discussion of why wealth management is an important part of the

Morgan Stanley investment thesis, please see our December 2014 report "Morgan Stanley's Wealth Management Is Underappreciated."

For those who are concerned over macro factors affecting wealth management firms, such as interest rates and equity market levels, we view a pair trade of going short Raymond James Financial and long Stifel Financial or Morgan Stanley as reasonably isolating their valuation difference while hedging macro uncertainties.

Exhibit 14 Stifel Financial and Morgan Stanley Are Undervalued, While a Pair Trade With Raymond James Isolates a Material Valuation Difference While Hedging Macro Uncertainties

Ticker	Moat	Price to FVE	Price to 2017 Earnings	Price to Book	Price to TBV	Wealth Management %	IRA %	Fee Based %	Normalized ROE
BAC	Narrow	0.82	8.75	0.60	0.87	15%	20%	46%	9%
MS	Narrow	0.73	8.90	0.74	0.85	45%	20%	40%	9%
RJF	None	0.88	13.16	1.55	1.72	75%	35%	40%	15%
SF	None	0.69	10.65	0.93	1.78	60%	25%	18%	14%
WFC	Wide	0.79	10.67	1.41	1.83	10%	25%	30%	13%

Source: Company commentary, Company filings, Morningstar

- Alternative asset managers: APO.

While the finalized Department of Labor fiduciary rule included a positive change for alternative investment managers, we continue to believe that the rule will have a negative effect on these firms. The major change was that the best-interest contract exemption no longer has an explicit list of assets that the exemption can be used for. The initial proposal's list didn't include assets such as public nontraded real estate investment trusts and derivatives, so advisors using those products wouldn't have been able to receive any compensation related to those transactions. Without being paid for distributing or using those products, it's plain to see that usage of those products would decline.

While some alternative products are now technically allowed under the best-interest contract exemption, we think that pragmatically speaking, their use by advisors will decline. Many of these alternative products come with relatively high fees, and the bar for justifying them in a retirement account under a best-interest obligation is then much higher than more standard products such as mutual funds and exchange-traded REITs. The Department of Labor also stated that it would pay particular attention to the recommendation of these products, that advisors should document why their use is in the best interest of the client, and that continued monitoring of the investment past the initial recommendation may be needed to satisfy the best-interest obligation. The degree to which alternative asset management firms will be affected by the fiduciary rule therefore depends on the willingness and ability of the full-service wealth management firms to substantively justify these products in client portfolios.

Among alternative asset managers, we believe Apollo will be the most affected via its stake in Athene, but the ultimate impact is mixed. Athene, with about $45 billion in fixed-index annuities is the fourthlargest player in the U.S. after AIG, Allianz, and New York Life, and obtains about $3 billion in retail sales annually. With fixed-index annuities included under the best-interest contract exemption, it must work with its distribution partners to adapt. Adapting to the rule is no small task, as industry estimates put about 60%-65% of fixed-index annuity sales within qualified investment accounts affected by the rule. Apollo derives an estimated $400 million annually in management fees (about 45% of management fee revenue) from Athene, and owns a bit more than 10% of the entity with plans for an IPO likely within the next year, which could generate substantial additional incentive fees.

On the positive side, we believe the shift plays to Athene's strengths in sourcing attractive annuity blocks via acquisitions and reinsurance agreements where the cedent pays Athene to assume the liabilities. Athene has acquired all of its assets (about $60 billion) since 2011 from acquisitions, at a weighted average price/book value of 0.6, and we expect that as the space undergoes a period of dislocation, Athene will be well-positioned to acquire further assets at a discount, lowering its overall funding costs. Further, we do not expect a significant impact to Apollo's management fee revenue, as we do not expect existing assets under management to decline, and our fee growth expectations from Athene are mainly linked to our assumptions about Apollo's ability to further penetrate Athene AUM as a subadvisor, which is independent of the rule's impact.

Negative impacts include a drop-off in Athene's retail sales. Fixed-index annuities are not likely to resume the double-digit growth rates they experienced when fixed-index annuity sales increased to $55 billion in 2015 versus $27 billion in 2008. We would also expect Athene to either develop its own distribution capabilities (Apollo could use the recently acquired RCS Capital's wholesale distribution retail network) or rework existing distribution agreements to incorporate new annuity products that offer appropriate incentives to advisors. Further, valuations for annuity providers such as Athene are likely to decline, meaning our estimated incentive fees of $500 million to $1 billion to Apollo from an eventual Athene IPO are more likely to be in the $250 million to $500 million range, as the provider may trade at a discount to book because of the uncertainty.

- Life insurance companies: Ameriprise Financial, MetLife, Principal Financial Group, Prudential Financial. Life insurance companies were hit with one of the more negative surprises of the finalized rule, as fixed-index annuities that the initial proposal kept under the less-demanding prohibited transaction exemption 84-24 are being put in the best-interest contract exemption along with variable annuities. This likely forced some insurance companies to make a 180-degree shift in their contingency plans, as some were contemplating fixed-index annuity volumes replacing variable annuities. A major adaptation that we expect in the life insurance industry is more annuities being made that work well with fee-based accounts. According to Morningstar data, only about 4% of variable annuity sales are structured as fee-based instead of commission. We also believe that there will be a greater emphasis placed on benefit riders with variable annuities to validate their compensation payments, as the Department of Labor has expressed skepticism regarding the tax benefits of certain products when used within tax-qualified accounts.

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