Financials: More Resilient Than Feared



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Financials are the backbone of the U.S. economy, supporting money movement, risk transfer, and the availability of debt and equity capital that allows the rest of the economy to function and grow. We see key megatrends in financials as firmly intact. Two of the most important enduring themes are the growth and democratization of the private markets ecosystem and the rise of self-directed investing.

Sector Outlook

We see companies within the Financials sector navigating an increasingly complex environment, with varied implications across subsectors. Overall, this environment will create a wide range of opportunities as well as challenges.

- **Framing quality and growth in a structurally higher interest rate world.** Quality growth principles are as relevant as ever, though their expression in financials may look a bit different.
- **Alternative asset managers and the private markets ecosystem are emerging from a period of challenging headlines.** We believe business models are proving more resilient than feared.
- **The growth of self-directed investing remains a key secular megatrend.** While active trader engagement will continue to ebb and flow, we see steadily rising adoption over the coming years.
- **We are more cautious about digital assets, stablecoins, and tokenized equities.** While it remains relatively early days, we see limited moats and/or incremental utility for most digital asset-oriented businesses.

Rethinking Cyclical Financials in a Structurally Higher Rate World

While we are at our core fundamentally driven, bottom-up investors, it's important to recognize that, for the financials sector, macroeconomic factors (chiefly the overall health of the economy and the shape of the yield curve) are often the most important driver of how our companies, and their stocks, perform. While, as a rule, we avoid having a specific macroeconomic view as a primary driver of our investment thesis, we think it's important to consider the impact of a broad range of plausible macro scenarios and how they might affect our portfolio.

A key feature of the past couple of years, as distinct from much of the previous decade, is that we have been living in a higher-growth (both nominal and real), higher-interest-rate world. The factors that have gotten us here (namely deglobalization and onshoring, data center capex to support the AI buildout, and persistently high fiscal deficits) seem likely to remain in place for at least the next couple of years, perhaps longer. At the same time, the proliferation of large language models (LLMs) has weakened the perceived moats around some information services and fintech businesses that would historically have checked all of our "quality growth" boxes, leading to persistently lower valuation multiples for these stocks.

Collectively, we see these factors pointing to a solid backdrop (and perhaps also deeper moats) for certain cyclically-geared names such as regional banks and commercial real estate (CRE) brokers that are 1) benefiting from the uptick in economic growth and 2) are either difficult or impossible to replace with AI tools due to some combination of balance sheet intensity, regulatory moats, and/or direct involvement with physical assets (whether in their construction, management, or financing). Consistent with our quality growth principles, we remain highly selective about these names. For example, we avoid banks that have excessive customer or industry concentrations, including banking-as-a-service (BaaS) banks focused on serving fintechs.

Outlook

While investors have been appropriately concerned about the impact of the recent shift higher in rates on bank funding costs and CRE transaction activity, we believe third quarter earnings results point to most of these businesses as more resilient than feared in the face of an increasingly difficult rate environment.

Please see important disclosures on page 4.

The Private Markets Ecosystem

The alternative asset managers have faced a challenging backdrop recently, as optimism early in the year about continued improvement in realization activity was quickly replaced by a surge in concerns around valuations for software and related businesses facing the risk of disruption from AI. Semi-liquid private credit vehicles were at the epicenter of these concerns as they faced sharply increased investor redemption requests.

We believe that commentators who drew parallels to the global financial crisis or likened these redemptions to bank runs were somewhat misguided, or at least were exaggerating the risks. The industry has already begun to demonstrate that these fund structures, as well as the underlying investments within them, are in general far more resilient than the popular narrative suggested (helped by broad diversification and appropriate asset-liability matching; the latter is a point we feel much of the financial press got wrong). Fire sales were largely avoided and reduced appetite for these funds from some investors has not translated to a broad-based deterioration in credit availability.

While we believe risks related to prolonged distributed-to-paid-in (DPI) headwinds, slower wealth channel inflows, and performance headwinds for some fund vintages are worth taking seriously, much of this risk is discounted in shares today, with most names trading at wide discounts to historical multiples based on our data. More importantly, we see fee-paying AUM growth, in our opinion the most important KPI, as firmly intact for most managers. Specifically, we see managers with strong performance track records successfully raising flagship funds that are 15-20%+ larger than their predecessors, supporting robust revenue growth and margin expansion (as the fee-paying asset base scales much more rapidly than the required headcount to manage the assets).

Private companies represent a growing portion of the U.S. economy (according to recent research from Oppenheimer, the number of public companies in the U.S. has declined from 8,090 to 3,908), and we believe many companies will continue to choose to go private or stay private for longer. Staying private allows companies to put greater emphasis on managing for the long term without the distraction and conflicting incentives that come with managing public market perceptions and the quarterly reporting cycle. One need only look at the value appreciation of the largest tech companies prior to their IPOs to conclude that many investors would benefit from allocating an appropriately sized portion of their portfolios to private markets. We see the democratization of private markets, including recent regulatory trends in favor of the eventual inclusion of private markets in defined contribution plans, as an important contributor to the next leg of private markets AUM growth.

Consistent with our quality growth principles, we favor balance-sheet-light managers over those that have combined with life insurance companies. While we recognize the appeal of the captive flows that the life insurance model creates, we believe it adds complexity, regulatory uncertainty, and macro/credit sensitivity.

Given our discussion in the previous section, where we said a "higher for longer" rate environment is reasonably likely for the foreseeable future, a natural question is "won't that create significant headwinds for the alternative asset managers?" While it's certainly not an incremental positive for most alternative asset managers, we don't see it as an existential headwind either. Higher interest rates have created an opportunity for debt restructuring, capital solutions, and both GP- and LP-led secondary transactions, secular themes that our portfolios are currently positioned to benefit from.

Outlook

We expect gradual but steady improvement in retail net inflows into private markets (alongside continuing healthy institutional flows), which should put a floor under sentiment and support a recovery in alternative asset manager stocks.

The Global Rise of the Retail Self-Directed Investor

According to the Fed's 2025 Survey of Consumer Finances, only 56% of adults are direct or indirect participants in the stock market, while penetration outside the U.S. is generally even lower. With the generational wealth transfer well underway, we see the scope for younger, digitally native investors managing a greater share of their wealth on self-directed platforms. Agentic wealth management solutions remain early in their evolution, but we see the potential for them to support a broader swath of investors managing their own finances, including those who would like more guidance in financial planning but may not need or want a full-service advisor.

While we continue to see a very important place for human advisors for the foreseeable future, especially for larger customers with more complicated needs, we see the rising cost of advisor recruiting and retention, as well as uncertainty about how brokers will earn income on customer cash balances, potentially creating volatility in the stock prices of traditional wealth managers. As a result, our portfolios tend to lean toward self-directed platforms.

Outlook

Retail brokers' stocks have pulled back from their highs, which we mainly attribute to some slowing of trading activity since the summer. We are not too surprised by that slowing, because a very active period for retail engagement in the early part of the year, supported by several marquee tech IPOs, gave way to choppier markets and some fatigue in the AI trade. Despite the recent slowing, we continue to be encouraged by healthy new account acquisition, customer asset growth and the development of new product offerings such as agentic trading that serve an ever-broadening range of investor needs.

Areas of Caution: Staying Grounded in Quality

As investors, our performance will often be defined as much by the things we choose not to invest in as by those that we do. In this regard, we want to highlight the areas of the financials ecosystem where we are more cautious or underweight. As quality growth investors, we avoid businesses with unsustainable capital structures, regulatory uncertainty, and unclear moats.

We are cautious about stablecoin-focused companies and believe the limited market-cap growth of the major stablecoins suggests they are not gaining more widespread adoption outside of crypto trading. At the same time, we see traditional banks seeking to defend their position by more actively promoting tokenized deposits, which replicate many of the desirable features of stablecoins (e.g., instant settlement).

We are skeptical of the introduction of perpetual futures ("perps") to the U.S., which we view as analogous to the highly levered contract-for-difference (CFD) products popular in some international markets. The issue we see with the excessive leverage enabled by these products is that a large percentage of traders will lose all of their capital, making this a less sustainable source of asset growth and inherently deserving of a lower multiple (as we see for European brokers with large CFD-type businesses).

While we have similar concerns about the binary nature of prediction market contracts, we do see a variety of incremental use cases that could appeal to retail and professional investors, insurers and other financial intermediaries, and commercial companies across the size spectrum.

Outlook

The current regulatory environment has supported the rapid growth and development of several new asset classes and trading products. While an environment that supports innovation and experimentation is a positive, we see limited incremental growth opportunity for many of these newer products. Of the newer financial products that have grown rapidly over the past couple of years, we see prediction markets as having the most promise.

Bottom Line

While the macro and political environment remain in flux, we see a robust outlook for many of the major subsectors within financials over the next couple of years.

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