

# Financial Services Outlook and Top Picks for 2009

## Near-Term Fundamental Outlook Remains Dire, But We Believe the Risk of Underperformance More Limited

Financial | Financial Services

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### --Highlights

**Issued 2009 Outlook and Stock Picks.** William Blair's Financial Services Research Group issued its outlook and top investment ideas for 2009 after the market close on December 11: Visa (V \$52.95), Northern Trust (NTRS \$45.79), IntercontinentalExchange (ICE \$76.79), and Signature Bank (SBNY \$25.60) make up our official list (in order of market capitalization). Our one-year list is focused on names with better relative earnings visibility and/or balance sheet risk; therefore it is a smaller group. However, it is not a defensive list, as it includes names that we believe would move sharply higher in a market recovery. Our underlying assumption is that fundamentals will get worse before better, but the stock market will begin to discount a recovery some time during 2009. We also updated our long-term list (3-5 years), adding ACE Limited (ACE \$47.11) and Visa.

**Also Selected a More-Aggressive, Bounce-Back List.** We also constructed an unofficial "bounce-back" list that is more aggressive and is geared toward stocks that we believe would move sharply higher if broader market sentiment moves higher, despite poor near-term fundamentals: Bank of New York Mellon (BK \$26.01), Morgan Stanley (MS \$13.85), Marshall & Illsley (MI \$11.85), Affiliated Managers Group (AMG \$33.17), and GFI Group (GFIG \$3.25) (in order of market capitalization). As a result, we would include a few of these names within any well-balanced financial services portfolio for 2009. Some of these names could double with a change in sentiment and no dramatic change in fundamentals, in our opinion.

**Financial Group Performance in 2008 Among Worst in History.** It should go without saying that 2008 will go down as one of the worst years in global financial market history. The S&P Financial Index declined 59% year-to-date through December 12, arguably the worst performance since the Great Depression. No area within financial services has been spared and recent high areas of growth have been attacked—the hedge fund business model has been somewhat marred and the growth of derivatives curtailed in most areas.

**Our Performance Could Have Been Better.** It was nearly impossible to avert poor absolute performance within financials, and financials as a group significantly underperformed the overall market. Our one-year list slightly outperformed the financial benchmark (fifth consecutive year) and our three-to-five-year list modestly underperformed the financial benchmark (first time in five years). Our stock-picking was not conservative enough.

**Mark Lane, CFA**  
(312) 364-8686  
mlane@williamblair.com

**David Long, CFA**  
(312) 364-8435  
dlong@williamblair.com

**D.J. Neiman, CFA**  
312-364-8852  
dneiman@williamblair.com

**Near-Term Fundamental Outlook Remains Dire, But We Believe the Risk of Underperformance More Limited.** The fundamental outlook for financials heading into 2009 is very challenging, and visibility remains extremely limited. We believe every name within our coverage universe faces some serious near-term issues, which makes stock-picking a challenge. Financial markets are still not functioning properly and credit markets need to stabilize in order for the economy to recover and the financial services group to recover. That said, sentiment toward financials could not be worse, in our view, and we believe the group is oversold over any reasonable investment time horizon—limiting the risk of further underperformance in 2009.

**--Overview**

**Tough Year for Financials Goes Without Saying**

William Blair's Financial Services Research Group issued its 2009 outlook on December 11 after the market close that included our top investment ideas for the new year (please contact your William Blair & Company salesperson for a copy of the presentation). The report also includes an updated list of best ideas over the next 3-5 years and an unofficial bounce-back list for 2009 for those investors that are more aggressive and/or have a more constructive view that sentiment will turn "relatively" more positive toward financial stocks some time during 2009. This note includes a write-up for every company within each list and an industry update by subsegment. Our research universe covers a broad segment of financial services, including asset management, brokerage/investment banking, commercial banking, commercial property-casualty insurance, custody banks, exchanges, payment card networks (new in 2008), and specialty finance.

The right strategy for 2008 was to categorically avoid the financial service sector, as the year will go down as one of the worst in global financial market history. No area within financial services has been spared. The S&P Financial Index declined 59% year-to-date (12/12), arguably the worst performance since the Great Depression. Recent high areas of growth within the industry were attacked—the hedge fund business model was somewhat marred and the growth of derivatives of any type was curtailed. The adverse reaction to the bankruptcy of Lehman Brothers and the collapse of AIG in mid-September in the midst of an already skittish market caused nearly a complete, systemic breakdown of the global financial system. Economic activity came to a screeching halt in late September, pushing the U.S. further into recession and the rest of the world into recession—driving international equities markets significantly below the U.S. for the first time in several years. The residual response to the global credit crisis has driven risk aversion to levels that in many ways have never been seen before—two of the most visible include record-high corporate credit spreads and record-low short-term U.S. treasury yields. But the market is littered with evidence of extreme risk aversion and asset prices in most risk-oriented asset classes are sitting at historic lows and unsustainable levels, in our opinion.

**Financial Services  
Performance by Sector for 2008**

Indices	Performance <sup>1</sup> 12/05/07 - 12/08/08	Performance <sup>1,2</sup> 2007	Performance <sup>1,3</sup> 2006	Comments
S&P Financials	-55.5%	-16.7%	14.2%	In 2008, there were limited places to hide within the financial services space given the significance of the market sell-off and the breadth of market dislocation. Sectors that were viewed as more defensive in 2007, including exchanges and certain insurance segments, also collapsed.
S&P 500	-38.7%	3.5%	12.4%	
Consumer Finance	-55.7%	-15.3%	4.2%	Commercial property-casualty underwriters held up relatively well given modest credit exposure within their investment portfolios compared to life insurers. In addition, some signs of pricing stabilization within the commercial property-casualty industry also supported the group.
Custody Banks	-38.2%	18.4%	18.0%	
Major Investment Banks	-74.5%	-26.4%	37.6%	The trust banks also benefited on a relative basis from more limited credit risk and low cost capital injections through the U.S. Treasury's Capital Purchase Program.
Exchanges	-62.3%	32.3%	55.8%	
Comm'l P/C Underwriting	-31.2%	0.7%	8.9%	
Asset Management	-50.1%	14.8%	15.9%	
Financial Guaranty	-83.1%	-62.6%	12.9%	
Life Insurance	-56.9%	11.0%	10.5%	
S&P Banks	-48.3%	-27.1%	10.8%	
3-month LIBOR <sup>4</sup>	-57.5%	-3.7%	20.0%	

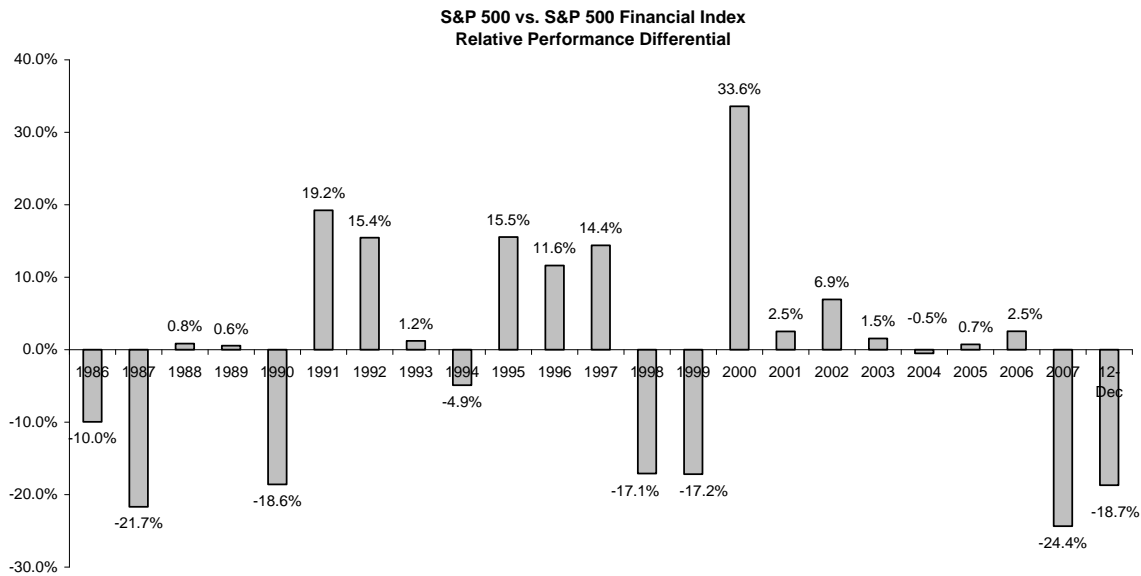
<sup>1</sup>Diversified groups are market capitalization weighted.

<sup>2</sup>Data from 12/06/06 through 12/05/07.

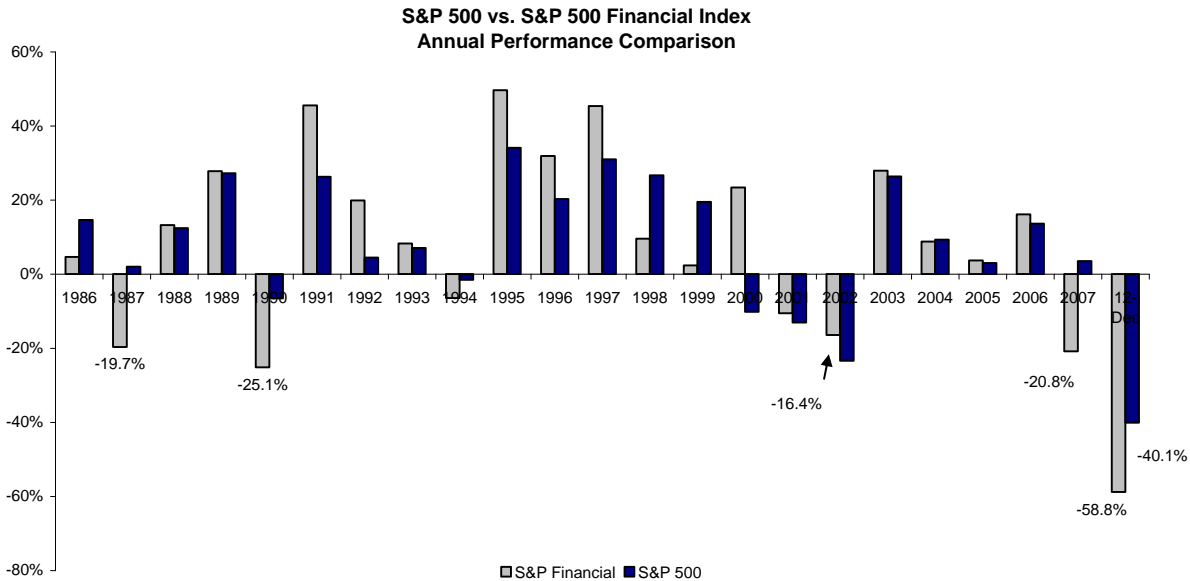
<sup>3</sup>Data from 12/07/05 through 12/06/06.

<sup>4</sup>3-month LIBOR decreased from 5.15% at 12/05/07 to 2.19% on 12/08/08.

Source: FactSet



Source: Bloomberg, year-to-date performance through December 12, 2008.



Source: Bloomberg, year-to-date performance through December 12, 2008.

It was impossible to avert poor absolute performance, and financials as a group significantly underperformed the broad market. Our one-year list slightly outperformed the financial benchmark (fifth consecutive year) and our three-to-five-year list modestly underperformed the financial benchmark (first time in five years). Our stock-picking was not conservative enough, although long-term relative performance remains respectable.

**William Blair & Company, L.L.C.**  
**Financial Services Group Performance**  
**Best Idea and 3-5 Year Lists: 2004-2008<sup>1,2</sup>**

<b>Annualized Since Inception: 1 Year List</b>		<b>Annualized Since Inception: 3-5 Year List</b>	
S&P Financial Index	-7.7%	S&P Financial Index	-11.1%
S&P 500 Index	-16.4%	S&P 500 Index	-16.4%
	-5.0%		-5.0%
<b>2008: One Year List Average</b>		<b>3-5 Year List Average</b>	
S&P Financial Index	-57.6%	S&P Financial Index	-61.0%
S&P 500 Index	-58.0%	S&P 500 Index	-58.0%
	-39.5%		-39.5%
<b>2007: One Year List Average</b>		<b>3-5 Year List Average</b>	
S&P Financial Index	-10.9%	S&P Financial Index	-1.2%
S&P 500 Index	-15.1%	S&P 500 Index	-15.1%
	5.1%		5.1%
<b>2006: One Year List Average</b>		<b>3-5 Year List Average</b>	
S&P Financial Index	18.9%	S&P Financial Index	19.6%
S&P 500 Index	14.2%	S&P 500 Index	14.2%
	12.4%		12.4%
<b>2005: One Year List Average</b>		<b>3-5 Year List Average</b>	
S&P Financial Index	11.1%	S&P Financial Index	14.8%
S&P 500 Index	6.2%	S&P 500 Index	6.2%
	6.3%		6.3%
<b>2004: One Year List Average</b>		<b>3-5 Year List Average</b>	
S&P Financial Index	37.3%	S&P Financial Index	8.2%
S&P 500 Index	3.1%	S&P 500 Index	3.1%
	4.5%		4.5%

<sup>1</sup>2008 performance measured from 12/5/07-12/10/08.

<sup>2</sup>Annualized performance since inception includes each new list for annual measurement period.

**Near-Term Fundamentals Remain Dire, But We Believe the Risk of Underperformance Is More Limited**

The outlook for financial services companies heading into 2009 is as poor as it has been in decades, with limited visibility. Consensus expectations reflect negative GDP growth through the first half, rising consumer and corporate credit losses, lower inflation, unemployment peaking in late 2009/early 2010, and continued reductions in the fed funds rate. Federal funds futures imply virtually a 100% probability the Fed lowers rates 50 basis points on December 16 and greater than a 50% probability the move is greater than that—the current 1.00% fed funds level already matches a record low.

Further aggressive policy action from the new administration is imminent; a massive economic stimulus plan and further expansion of the Federal Reserve balance sheet to fund further programs to restore market liquidity and investor confidence. Credit markets are still not operating normally, as confidence has been badly shaken, and therefore accommodative Fed policy and other regulatory responses have not yet had the desired impact. One of the only visible positives has been the narrowing of the record spread between LIBOR and short-term treasury rates—although the difference between the two remains at a significant gap. We expect the government to provide support and spend aggressively until credit markets stabilize and the new administration's tax and other policy agenda items will significantly lag original implementation expectations, given current market conditions, in our opinion.

There are no easy answers, but dealing with the increased residential housing foreclosure wave is critical, as there are no real signs of a bottom in the residential housing market. We believe improving housing affordability is easy to achieve; however, dealing with the negative equity issue with the prospects that higher unemployment remains more problematic, the government and/or the banks will have to absorb these losses. Furthermore, we do not expect lending activity to improve until banks have a better handle on their ultimate loss expectations. U.S. residential housing prices have declined about 23% through September 2008 from the peak in mid-2006 (Case-Shiller national home price

index). The consensus view is generally for a bottoming in late 2009/early 2010 with a peak-to-trough decline in the 30% to 35% range.

With no major recovery in 2009, revenue growth is likely to come in select areas, driven by heightened risk aversion, increased regulation, and/or market share gains in businesses facing competitive degradation. These trends aid certain areas of certain companies on our list, but may be overcome by other negative factors including intense competition, in our opinion. These trends should aid (at least in the near term) growth in bank deposits, growth in cash management products including money market funds, the movement of OTC derivatives to centralized clearing, demand for risk management services, demand for outsourcing services (custody bank-related) and increased demand for financial advice. Over the long term, we continue to believe in the growth of alternative investments (e.g., commodities, ETFs, hedge funds, and private equity), emerging markets insurance, global capital markets development, custody services, and wealth management.

With that background and despite the difficult fundamental backdrop, we believe the financial services segment as a group is oversold over any reasonable investment time horizon and the risk of underperformance in 2009 is more limited. We expect continued volatility in the near term, as the financial markets adjust to regulatory and legislative actions. However, valuation levels in almost every area we cover are well below average or still close to recently established trough levels—and unlike past years many non-financial sectors face significant challenges as well. From a subsegment perspective, we are the most constructive on the custody banks, exchanges, and payment card networks. We are neutral on asset management, brokerage/investment banking, commercial banking, and commercial property-casualty insurance. We are negative on specialty finance. Business models that will remain under attack and in transition include those dependent upon wholesale funding—including repurchase agreements and securitization—principally the large, leveraged investment banks and many companies within consumer and commercial finance.

### **Our One-Year List Focuses on Better Relative Earnings Visibility and/or Balance Sheet Risk**

Our one-year list reflects names with better relative earnings visibility and/or balance sheet risk and therefore is a smaller group—the list also offers exposure to three subsegments that we believe each have favorable long-term opportunities—custody banks, exchanges, and payment card networks. Our goal with this list is to outperform the financial services group assuming some sustained recovery in equity markets in 2009. While our one-year list is focused on relatively lower risk, it is not a defensive list, as it includes names that we believe would move sharply higher in a market recovery. Our underlying assumption is that fundamentals will get worse before better, but the stock market will begin to discount a recovery some time during 2009. A defensive list would include more property-casualty insurance names and less credit-sensitive names.

#### **William Blair & Company, L.L.C. Financial Services Group Best Stock Picks For 2009**

<b>Company</b>	<b>Ticker</b>	<b>12/10/2008 Market Cap</b>	<b>Rating/ Profile</b>	<b>12/10/2008 Price</b>	<b>2008E EPS</b>	<b>2009E EPS</b>	<b>2009E P/E</b>	<b>Div. Yield</b>
Visa Inc.	V	\$45,291	O/C	\$53.16	\$2.25	\$2.60	20.4x	0.8%
Northern Trust Corporation	NTRS	\$11,176	O/C	\$50.27	\$4.40	\$3.95	12.7x	2.3%
IntercontinentalExchange, Inc.	ICE	\$8,254	O/A	\$77.47	\$4.51	\$5.30	14.6x	NM
Signature Bank	SBNY	\$808	O/A	\$27.77	\$1.34	\$1.70	16.3x	NM
<b>Average (unweighted)</b>							<b>16.0x</b>	<b>1.5%</b>
<b>S&amp;P 500 Financials Index</b>				<b>\$168.23</b>				
<b>S&amp;P 500 Index</b>				<b>\$899.24</b>	<b>3.1%</b>			

Source: FactSet, Thomson Financial, William Blair & Company, L.L.C. estimates.

### Our Three-to-Five-Year List Focuses on Long-term, Growth Franchises

Our goal with the three-to-five-year list is to identify quality long-term franchises without respect to timing or valuation. We are willing to stick with out-of-favor business models or stocks, and we adopt a portfolio approach. This group of companies also remains more geared toward capital-market-exposed companies, given William Blair's growth stock research orientation. We make changes only one time per year no matter how embarrassingly individual stories may develop. This year we added ACE Limited, which provides some balance given the capital markets bias within the list and the removal of non-capital market sensitive names. ACE is the only insurance name on the long-term list. We also added Visa, which represents high-quality, visible growth with strong secular drivers. Visa was a new addition to our research coverage universe in 2008. ACE and Visa replace AIG (AIG \$1.80) and Ambac (ABK \$1.38), which were dropped during 2008 given our lack of confidence in their respective business models.

**William Blair & Company, L.L.C.**  
**Financial Services Group**  
**Best Stock Picks for the Next 3-5 Years**

Company	Ticker	12/10/2008 Market Cap	Rating/ Profile	12/10/2008 Price	2008E EPS	2009E EPS	2009E P/E	Div. Yield
Visa Inc.	V	\$45,291	O/C	\$53.16	\$2.25	\$2.60	20.4x	0.8%
Goldman Sachs Group, Inc. (The)	GS	\$28,776	O/C	\$71.53	\$4.99	\$8.35	8.6x	2.0%
ACE Limited	ACE	\$16,432	O/C	\$47.96	\$7.81	\$7.50	6.4x	2.3%
CME Group Inc.	CME	\$14,595	O/C	\$221.37	\$15.98	\$16.00	13.8x	3.0%
Northern Trust Corporation	NTRS	\$11,176	O/C	\$50.27	\$4.40	\$3.95	12.7x	2.3%
T. Rowe Price Group, Inc.	TROW	\$8,819	O/C	\$34.44	\$2.01	\$1.40	24.6x	2.7%
Affiliated Managers Group, Inc.	AMG	\$1,372	O/C	\$36.70	\$5.45	\$4.00	9.2x	NM
PrivateBancorp	PVTB	\$928	O/C	\$27.90	(\$1.02)	\$1.05	26.6x	1.1%
<b>Average (unweighted)</b>							<b>15.3x</b>	<b>2.0%</b>
<b>S&amp;P 500 Financials Index</b>				<b>\$168.23</b>				
<b>S&amp;P 500 Index</b>				<b>\$899.24</b>		<b>3.1%</b>		

Source: FactSet, Thomson Financial, William Blair & Company, L.L.C. estimates.

### Bounce-Back List Provides Most Upside, But Much More Aggressive—"Think Change in Sentiment Before Change in Fundamentals"

Given the ambiguity in the environment, we also constructed an unofficial bounce-back list that is more aggressive and is geared toward stocks that would move sharply higher if broader market sentiment moves higher despite poor near-term fundamentals. This group of companies is less about near-term fundamentals and more about changes in near-term sentiment. As a result, we would include a few of these names within any well-balanced financial services portfolio for 2009. Some of these names could double with no dramatic change in fundamentals, in our opinion. However, this bounce back list does include the most aggressive names within our coverage universe that have the potential to face even more serious near-term headwinds.

**William Blair & Company, L.L.C.**  
**Financial Services Group**  
**Best Stock Picks 2009—"Bounce Back" Ideas**

Company	Ticker	12/10/2008 Market Cap	Rating/ Profile	12/10/2008 Price	2008E EPS	2009E EPS	2009E P/E	Div. Yield
Bank of New York Mellon Corp (The)	BK	\$31,707	O/C	\$28.71	\$2.84	\$2.90	9.9x	3.3%
Morgan Stanley	MS	\$15,898	M/C	\$14.60	\$3.11	\$2.50	5.8x	7.4%
Marshall & Illsley Corporation	MI	\$3,681	O/C	\$12.70	(\$0.33)	\$1.36	9.3x	9.9%
Affiliated Managers Group, Inc.	AMG	\$1,372	O/C	\$36.70	\$5.45	\$4.00	9.2x	NM
GFI Group Inc.	GFIG	\$357	O/A	\$3.28	\$0.55	\$0.60	5.5x	6.4%
<b>Average (unweighted)</b>							<b>7.9x</b>	<b>6.8%</b>
<b>S&amp;P 500 Financials Index</b>				<b>\$168.23</b>				
<b>S&amp;P 500 Index</b>				<b>\$899.24</b>		<b>3.1%</b>		

Source: FactSet, Thomson Financial, William Blair & Company, L.L.C. estimates.

## **Industry Subsegment and Company Details**

### **Asset Management (DJ Neiman)**

#### **Overview**

Consistent with our belief that the macroeconomic environment is likely to get worse before it gets better, our near-term outlook for asset managers is guarded, as fundamentals are weak and visibility is low. We see near-term challenges for all companies under coverage as heightened redemption activity and market depreciation drive AUM/revenue/EPS degradation. Earnings are likely to come under additional pressure due to significant operating margin compression, despite cost reductions, amplified nonoperating losses, and potential impairment charges, in our opinion. We believe 2008 is certain to be a record year for redemptions from long-term mutual funds on an absolute basis—based on ICI data, 1988 organic decay was worse (outflows equal to 5% of beginning AUM) but assets were a mere fraction of current levels, and the resurgence of flows to risky asset classes will likely lag an overall improvement in markets, especially for retail investors, in our opinion.

However, growth should re-emerge in time and we believe the asset management business model remains attractive on a relative basis, given its recurring revenue and cash flow characteristics, relatively high margins, and minimal capital requirements. Moreover, we believe secular growth trends remain largely intact, despite the painful environment asset managers have endured. Key long-term growth trends continue to be driven by the retirement market and the shift from defined benefit to defined contribution plans, as well as packaged investment solutions and asset allocation products, the next generation of which is likely to increasingly include variations of principal protection and guaranteed income withdrawal benefits, in our view. In addition, we believe globalization will re-emerge as a long-term driver of growth given higher expected long-term GDP growth outside of the United States—we continue to favor firms with greater relative exposure to non-U.S. investors over the long term.

Much has been written about the continuing hedge fund shakeout, and estimates for the number of funds that will go out of business are high. There is little doubt, in our view, that industry regulation will increase and disclosures will be enhanced as a result of outsized losses relative to expectations, perceived risks of short selling, and a recent headline-grabbing case of outright fraud. While this has been a game-changing year for hedge fund managers and alternative investments in the main, we believe the relaxation of investment constraints on active managers will eventually regain momentum and alternative strategies that do not rely on excessive leverage or large directional bets will once again be demanded by institutional investors.

Lastly, we believe industry consolidation is likely to accelerate when markets stabilize, especially for segments of the business where scale is increasingly important (money markets). While barriers to entry (including consolidating distribution) have undoubtedly increased over the past several months, we continue to believe that high-quality small-to-midsize boutique equity managers with strong investment performance can thrive going forward. In addition, we believe divestitures from corporate owners, and distressed sales could precede a normalized market environment.

Asset management stocks have underperformed year-to-date after coming under severe pressure in September given steep market declines, several downward earnings revisions, and significant multiple contraction. However, the peer group has bounced over the past few weeks from near trough levels and is currently trading at about 14 times 2009 estimates on average and at about a 15%-17% premium to the S&P 500, which is roughly in line with its five-year average and ahead of long-term multiples, which have been in line with the market on a relative basis.

#### **Stock Selection – Affiliated Managers Group (Three-to-Five-Year List and Bounce-Back List)**

We are keeping Affiliated Managers Group on our long-term list, as we believe it continues to represent the most dynamic growth story in asset management. While we think risks remain elevated in the near term, due to the weak fundamental backdrop, we believe AMG would likely outperform on an absolute and relative basis in the event of a sustained market recovery. Therefore, we are also including it on our best ideas bounce-back list. We believe recent scrutiny of the company's business model and financial leverage would dissipate in a recovery, AUM would likely benefit from the company's high relative equity market exposure, and AMG would likely be a price setter as the M&A market for high-quality boutique equity managers re-emerged and its cash preservation focus moderated.

We continue to view AMG as an investment in some of the highest-quality small-to-midsize asset management firms. Eight affiliates—AQR Capital, BlueMountain, First Quadrant, Friess, Genesis, Third Avenue, TimesSquare, and Tweedy Browne—generate about 80% of EBITDA; and with average AUM growth of 125% since investment, major affiliates have built a significant cushion to revenue share agreements. In addition, the structure of its transactions mitigates negative operating leverage at the holding company—this relative advantage should become increasingly evident over the next few quarters as cost-cutting efforts at larger integrated firms will not likely be deep enough to offset declines in revenue, in our opinion.

Longer term, we believe AMG is well positioned to garner inflows when risk aversion abates due to solid long-term investment performance and excellent equity style diversification—equities generate more than 80% of EBITDA, including 30% international, 30% U.S. growth, 15% U.S. value, and 8% emerging markets. We believe deals offer growth opportunities not available to most asset managers, and AMG remains the succession planning partner of choice for high-quality boutique equity managers who wish to remain independent and retain an equity interest in their business, in our view.

We see the company's competitive position as strengthened when markets stabilize, given fewer buyers, consistent succession-oriented transaction opportunities driven by demographics, and the potential for increased sales by corporate parents driven by capital needs. We also view distribution initiatives as a driver of increased organic growth over the long term. AMG has an established distribution platform in Australia, as well as efforts targeting the Middle East. More recently the company added resources to focus on continental Europe.

AMG shares trade at about 8 times our below-consensus 2009 cash EPS estimate about a 40% discount to peers compared with a long-term average discount of about 20% (range of 50% discount to 6% discount). Since the company's IPO in November 1997, shares have traded at an average multiple of about 15 times forward estimates with a range of 6 times to 32 times. We view shares as oversold relative to long-term earnings power and valuation as attractive for long-term investors.

#### **Stock Selection – T. Rowe Price Group (Three-to-Five-Year List)**

We are maintaining T. Rowe Price our 2009 long-term best picks list, as we continue view it as the highest-quality asset manager in the space and a core holding for growth managers. The company benefits from a sterling reputation and franchise, a solid execution record, and a well-respected management team that maintains a long-term and client-centric focus. In addition, T. Rowe has a broad equity, fixed income, and money market product offering and has delivered consistent investment performance across market cycles (65%, 78%, and 89% of assets in long-term mutual funds are outperforming peers over 3, 5, and 10 years)—this combination should help retain client AUM in the challenging near-term environment, as well as maintain best-in-class organic growth when markets stabilize, in our view.

Longer term, we view T. Rowe Price as the best-positioned firm on our list to capitalize on secular growth opportunity in the retirement market, which provides greater stability and more consistent net flows—retirement-date funds have nearly doubled at T. Rowe over the past two years and should continue to benefit from automatic employee enrollment in 401(k) plans and automatic escalation, in our view. In addition, we believe international distribution efforts will continue to generate incremental inflows over time. Non-U.S. clients equal 10% of total AUM and TROW was not able to sell products abroad until 2000 due to joint venture. Lastly, T. Rowe benefits from solid financial characteristics, including a strong balance sheet with no debt, over \$3 per share in cash and an additional \$2 per share in investments as well as industry-leading operating margins, despite near-term pressure.

T. Rowe shares trade at 22.5 times our 2009 EPS estimate, compared with a long-term average multiple of forward earnings of about 20 times and a range of 12 to 29 times. The company's multiple has held up on a relative basis, given a flight to quality among the group, in our opinion. Current valuation is at nearly 60% premium to the asset management peer group (long-term average is about a 20% premium), which may limit near-term upside potential, despite our view that investors should continue to focus on the highest-quality names in the space over the short to intermediate term. Our near-term concerns include operating margin compression, the likelihood of impairment charges on its seed investments, and the deteriorating employment situation, which could eventually affect 401(k) business, in our view.

## Brokerage/Investment Banks (Mark Lane)

### Overview

The outlook for the large investment banks (Goldman Sachs [GS \$67.74] and Morgan Stanley on our list) has never been more challenging with certain aspects of the full-service investment banking business under attack and near-term earnings visibility extremely limited. Fiscal fourth quarter 2008 results are likely to be among the worst in the history of the industry. Key revenue drivers, underwriting of any type and M&A, have plummeted since mid-September 2008. While we believe pent-up demand is significant in these areas, these businesses will not recover until confidence levels and credit markets improve more broadly. The only major capital markets activity over the past few months has been government-led investments or government-guaranteed issuance.

Trading activity has also stalled in many asset classes; including commodities, given a reduction in alternative asset levels, tighter credit conditions, intense volatility, and a breakdown in correlations between asset classes. OTC markets have been hit particularly hard, given concerns regarding counterparty risk. A shift toward exchange-traded markets and centralized clearing of trading in key markets should mitigate pressure on OTC markets over time, in our view, and reduce capital requirements for the major dealers participating in those markets. The move of OTC CDS trading to centrally cleared markets should also help the interdealer brokers serving these markets, in our opinion (GFI Group on our list). We believe that the market badly misunderstands the role of the interdealer brokers in providing trading liquidity to cash and derivatives trading markets.

The full-service investment banking business model can survive over time, in our opinion, but in the near term we expect leverage ratios to decline, more stable funding sources to be sought, and excessive risk-taking to be reduced. We believe the industry is set for a secular period of simplification and will continue to consolidate in the near and intermediate term. The business and the balance sheet of the major firms need to be simplified adequately for investors to be comfortable enough to provide unsecured funding for the business at reasonable terms—the length of this transition is uncertain, but will likely take up much of 2009, in our opinion. The major standalone firms—Goldman and Morgan—cannot adequately fund themselves without government support in the near term.

What we expect to emerge out of this period for Goldman Sachs and Morgan Stanley is a business model that is still capital markets driven (more so at Goldman than Morgan Stanley) and capable of generating 15%-20% ROE over time. However, the business model will also include a larger bank deposit base to fund certain business operations. We believe investors generally misunderstand the role of using bank deposits to fund certain operations. For instance, Goldman has recently identified only about \$130 billion of its \$1.1 trillion of assets as of August 31, 2008, that can be placed inside a bank and be funded by deposits.

While leverage, returns, and risk-taking will be reduced, the basics of the full-service model—M&A advisory, advising on capital raising, and the facilitation of client trading in every asset class globally—will not change. Market leaders will emerge stronger, in our view, and we remain bullish on the long-term development of global capital markets. Growth opportunities remain compelling in emerging markets, derivatives, and alternative investments—although the drivers coming out of this cycle will be basic M&A and debt/equity underwriting.

Investment bank price-to-book multiples remain modestly above recently established record-low levels and significantly below long-term potential levels (at least 100%-200%), in our opinion. We believe P/E multiples for brokerage related stocks (FCStone [FCSX \$4.39], GFI Group, and Penson Worldwide [PNSN \$6.59] on our list) discount a sharp reduction in activity levels in 2009 and a muted recovery period. While valuations appear to discount a vast majority of the bad news, we remain selective in the near term, and we did not include investment banks and/or brokerage-related names on our one-year list given the lack of near-term visibility, but this should be one of the first groups to rally in a market recovery; hence we have included Morgan Stanley on our bounce-back list solely because of valuation relative to Goldman. In addition to limited visibility for trading activity, the investment banks are also exposed to further write-down risk in key asset balances that remain under pressure—commercial-mortgage related, leveraged loans, principal investments, and residential-mortgage related.

**Stock Selection – GFIG Group (Bounce-Back List)**

GFI Group is a leading interdealer broker (IDB) concentrating in OTC trading markets: cash (20%) and derivatives (80%). It was the fourth-largest of the five major firms based on 2007 revenue and the fastest-growing based upon our estimate, given its heavier emphasis on derivatives overall and credit derivatives specifically. The company also has a very small interest rate business, which is the largest yet slowest-growing OTC market. In 2007, GFI's split of revenue was 34% credit, 25% equity, 21% financial, and 21% commodity—48% Europe, 43% North America, and 9% Asia.

The primary reasons we placed GFI on our bounce-back list is that: 1) we believe the IDB business model is relevant but badly misunderstood, 2) we believe in the long-term growth drivers of the market, 3) we believe the company faces minimal balance sheet and funding risk in the near term, and 4) the economics of GFI's business is not tied to short-term interest rates to the same extent as other execution-oriented brokerage business (includes FCStone, optionsXpress [OXPS \$11.81], and Penson on our list).

Although under scrutiny, we believe the IDB business model is well established and will continue to offer an important source of trading liquidity for its major customers—the major dealers and increasingly larger buy-side organizations. The movement of OTC CDS trading to centralized clearing should only help the long-term growth of the overall credit derivatives market, and GFI should also benefit as a market leader. For instance, the OTC energy trading market has moved toward centralized clearing since the collapse of Enron in 2002, and the interdealer brokers have been large participants in that growth. In addition, GFI can participate in the growth of products that move to exchange-traded markets—its second-largest business is equities, which is an exchange-traded business.

GFI does not hold any significant market risk and because it does not hold customer cash the company has limited credit risk and its earnings are not highly sensitive to changes in short-term interest rates. Its primary credit exposure is receivable risk associated with the failure of a major customer, although GFI lost less than \$5 million after-tax due to the bankruptcy of Lehman Brothers. The company also has no major funding needs in the near term and the “net” debt under its credit facility is almost zero, with the facility maturing in 2011.

Near-term trends are very challenging, given the significance of recent market dislocation, tighter credit conditions, and reduced risk taking. GFI may face downward earnings revisions, but we believe this risk is already largely discounted in current valuation. However, we again stress that a bounce-back list idea is more about sentiment and less about near-term fundamentals, in our opinion.

The shares trade at 5.4 times our 2009 EPS of \$0.60, although this estimate could prove aggressive, and therefore valuation is difficult to frame for a business valued on earnings growth. We view “normalized” EPS power in 2009 at a minimum of \$0.60—15% operating margin off of \$800 million revenue (down 20% in 2009). Placing at least a 10-times P/E multiple on that number with an improvement in the environment appears reasonable, in our opinion, and would result in a double from the current level. If the environment improves in 2010 and EPS actually increase, then the stock could move to up by 3 to 4 times some over the next 12 to 18 months.

Our primary concern is the prospects for very weak growth in 2009 (down 20-25%), which could cause the company to lose money in the first half of 2009 and require more aggressive actions to eliminate even more unprofitable trading desks, creating sloppy results and disinterest for the name throughout 2009.

**Stock Selection – Goldman Sachs (Three-to-Five-Year List)**

Goldman Sachs is a leading global investment bank, trading firm, and asset manager—over 50% of net revenue is generated from outside the United States. The net revenue breakdown for fiscal year 2007 (less distortions than 2008): investment banking, 16%; asset management/prime brokerage, 16%; equity commissions/trading, 25%; FICC, 35%; and principal investments, 8%.

Goldman remains on our long-term list, because we view it as among the highest-performance plays on the expansion of global capital markets and the best-positioned global investment bank that should emerge from this period stronger on a relative basis. The firm holds leading market share in high-

margin M&A and equity-related underwriting, which both feed other business lines. Its trading activities are diverse and benefit from its global franchise with high barriers to entry—it remains a leader in commodities, credit, and foreign exchange. It also operates an emerging asset management business (\$863 billion of AUM as of 8/08) with heavy emphasis on alternative investments (18% of total AUM) and a very profitable prime brokerage business.

Importantly, Goldman's execution and risk management has been impressive, and it has outperformed its peers in both favorable and unfavorable markets; we have a higher degree of conviction in management's ability to successfully navigate through the next several quarters relative to its peers. Until the fiscal fourth quarter (ending November 2009), the company has not lost money, and it managed to avoid a material exposure to the subprime RMBS market, which led to the collapse of major competitors Bear Stearns, Lehman Brothers, and Merrill Lynch.

Still lost on many investors is that Goldman's near-term funding risks have been eliminated given its conversion to a bank holding company and participation in the FDIC-backed debt issuance program, under which it has issued more than \$7 billion. We expect the company to reduce leverage (assets to equity) and risk further in the near term and work to aggressively expand its deposit funding, which could include a bank acquisition.

We view valuation as washed out, with the shares trading at a price-to-book multiple of only 0.70 times and a price-to-tangible book multiple of only 0.80 times (November 30, 2008 estimate). Our primary near-term concerns include a lack of visibility in business trends and the prospects for further write-downs, given the continued slide in asset prices globally and unprecedented volatility. This lack of relative visibility is the main reason we did not include Goldman on the official one-year list, although the stock remains an early cycle play. Fiscal 2009 should serve as a transition year, with the size of the balance sheet shrinking further and risk being further reduced, all aimed at restoring confidence in Goldman's franchise. Ultimately, Goldman will emerge with a business mix and a balance sheet that should allow the firm to generate average ROE of 15%-20%, although the timing toward that goal remains uncertain.

#### **Stock Selection – Morgan Stanley (Bounce-Back List)**

Most of the key characteristics of Goldman Sachs highlighted above also apply to Morgan Stanley. However, two of the key differences is that trading and principal investments is a modestly lower contributor to earnings at Morgan Stanley versus Goldman, and Morgan Stanley's trading and risk management performance has been worse than Goldman during the current downturn so far (lost \$3.6 billion in fourth quarter 2007). However, Morgan Stanley also maintains leading positions in M&A and equity-related underwriting, and its breadth of trading operations also rival Goldman.

Despite this profile, Morgan Stanley has been among the hardest-hit names within financial services that has a long-term, viable business, in our opinion. It should also be among the earliest of early-cyclical financial services names to recover with a change in sentiment (hence appropriate for a bounce-back list name, in our view).

The shares trade at a price-to-book multiple of only 0.46 times and a price-to-tangible book multiple of only 0.52 times (November 30, 2008 estimate). The shares trade at a noticeable 35% discount to Goldman Sachs, given its less favorable risk management record during the downturn and its perceived vulnerability relative to Goldman Sachs (e.g., think about what happened to Citigroup). The issues remain poor near-term earnings visibility, further write-down risk in troubled asset areas, and its balance sheet/business remains in major transition during 2009.

#### **Commercial Banks (Dave Long)**

##### **Overview**

The current backdrop facing the commercial banking segment is challenging—rising credit costs, intense competition for deposits, and irrational credit markets. As a result, banks underperformed significantly in 2008, and the regional bank group has now underperformed the broader equity markets since the beginning of 2004. That said, commercial banks historically have started to outperform the

broader equity markets shortly after the midpoint of a recession and before an improvement in their fundamentals becomes evident.

Commercial banking capital ratios have been boosted by the U.S. Treasury's TARP Capital Purchase Program. The crux of the investment by the federal government (using taxpayer dollars) is to stimulate loan growth in order to reinvigorate economic growth. However, most banks' capital levels remain at relatively low levels, given the uncertain economic environment, and are likely to delay increasing loan origination activity until the economic outlook improves. We believe loan growth will remain benign in 2009.

The credit environment deteriorated further in 2008; NCOs and NPAs are well above the peak earlier this decade. We expect credit costs to continue to rise across the board, particularly for consumer and commercial and industrial loans. We believe the extent of credit-quality deterioration is uncertain.

Commercial bank net interest margins expanded somewhat in the third quarter, but deposit pricing pressure is offsetting the usual benefits of a steep yield curve. We expect modest net interest margin improvement in 2009.

We expect cost cutting to be a theme for 2009. We have already witnessed broad-based layoffs at some of the larger banks, and expect employee reductions to be felt all the way down to the community bank level. In addition to lower compensation costs, we expect other spending reductions to include information technology and travel and entertainment. Despite expense rationalization, we expect positive operating leverage to be a challenge for commercial banks in 2009.

#### **Stock Selection – Signature Bank (One-Year List)**

Our top stock selection in commercial banking for the next 12 months is Signature Bank. We expect solid EPS growth to drive strong stock performance over the next year. We believe better-than-peer EPS growth will be driven by Signature's ability to capture market share from its larger bank peers via attracting veteran bankers, improving its earning asset mix, and realizing relatively modest credit costs.

In the challenging economic environment, we are more comfortable with Signature's risk/reward profile than other commercial banks. Its balance sheet is deposit driven, loans represented 62% of deposits at September 30, and we view it as a relatively conservative lender. Additionally, we expect its net interest margin to expand more than its peers in 2009, as loans become a larger percentage of earning assets. Loans represented only 47% of average interest earning assets in the third quarter; loans carry a higher yield than the investment securities they are replacing.

Its shares trade at 15 times our 2009 EPS estimate, well below our 3-5 year EPS growth forecast of 20%. Its P/E multiple-to-growth ratio of 0.8x compares to 1.4x for its closest peers. We believe a premium multiple to its growth rate and at least an in-line multiple with its peers is warranted. We expect Signature's shares to fully participate in a commercial bank stock price recovery.

We view Signature's biggest risk as credit risk. While we believe its NCOs will remain below peer, it is not immune to the challenging economic backdrop, particularly the health of the New York City market, as 100% of its business is in that market.

#### **Stock Selection – PrivateBancorp (Three-to-Five-Year List)**

PrivateBank's shares provide investors with an opportunity to own a rapidly growing financial institution that caters to middle-market businesses, affluent families and individuals. Its Strategic Growth Plan provides a unique long-term growth opportunity and will drive better-than-peer EPS growth over the next several years, which we believe will lead to attractive stock-price performance. The company reached an inflection point in the third quarter, as its Strategic Growth Plan hiring is complete with infrastructure in place to produce significant positive operating leverage going forward; we expect revenue growth to accelerate while expense growth decelerates. We believe the plan is economically superior to acquiring a whole bank, and we view its incentive compensation structure as aligned with shareholders (the compensation plan is tied to stock-price appreciation and EPS growth).

The addition of roughly 140 managing directors since the fourth quarter of 2007 and the impact of the recession on credit quality dilute near-term EPS and cloud 2009 EPS visibility; however, we forecast 2010 EPS of \$2.80. Therefore, its shares trade at less than 10 times our 2010 forecast, which we view as relatively inexpensive given our expectations of at least 20% EPS growth in 2010–2012.

The key risk for PrivateBank, particularly in 2009, is credit quality, more specifically, its exposure to builders and developers. While we view PrivateBank as a relatively conservative lender and applaud recent decisions to tighten lending standards, it is not immune to credit risk.

#### **Stock Selection – Marshall & Illsley (Bounce-Back List)**

M&I is one of the best-positioned regional banks in this challenging banking environment, and we expect M&I's shares to be among the best-performing regional bank stocks when the shares of commercial banks begin to outperform the broader equity markets. We believe M&I's shares offer great value and will experience multiple-expansion relative to its peers. Its shares trade at a 50% discount to its book value and 25% discount to its tangible book value—its peers trade at a 30% discount to book value and at a 10% premium to tangible book value.

While not immune from further loan quality deterioration, we believe that M&I is better reserved than its regional bank peers and that its loan loss reserve ratio of 2.05% is near its peak (its regional bank peer median is 1.50%). We believe M&I can continue to lever its deep product set (wealth management, C&I lending, and mortgage origination) into its non-Wisconsin Midwest markets (Indianapolis, Kansas City, Minneapolis, and St. Louis) and produce solid growth.

In addition to credit risk, M&I may reduce its quarterly dividend from its current level of \$0.32 per share and yield of 11%. That said, we believe a dividend reduction is largely priced into the stock.

#### **Commercial Property-Casualty Insurance (Mark Lane)**

##### **Overview**

We expect some stabilization in commercial insurance pricing in 2009 for the first time in at least four years, given pressure on industry capital levels due to the deterioration in credit/equity markets. We expect prices to stabilize first within the reinsurance markets and credit-oriented casualty lines of business (professional liability and general liability including excess coverage). However, we do not expect pricing to improve more broadly until earnings deteriorate more meaningfully, as many underwriters have still been generating record, or near record, underwriting margins during 2008. As a result, we are less optimistic about the opportunities for price increases in 2009 than what we believe is generally expected.

A lot of focus remains on AIG, and rightly so, given its leading market share in commercial lines, particularly in the United States. The crisis at AIG is driving increased business movement in the near term, but the company is also aggressively pricing business to maintain client retention levels. That said, we expect many clients to move away from AIG without even looking at renewal pricing; therefore, AIG's competitive degradation could contribute to some of the pricing stability we expect in 2009.

The property-casualty insurance in the aggregate has averted most of the carnage from the deterioration in credit markets, given relatively less equity market and credit risk within their investment portfolios (in general underwriters take risk in their underlying underwriting business and not within in their investment portfolios). That said, absolute performance still suffered in 2008, given the significance of equity market declines. Valuation levels are now well below average on an absolute basis for underwriters and average for insurance brokers—both groups have been among the best performers in 2008 on a relative basis, given their defensive characteristics and some dialogue regarding price stability. The level of the relative multiple for the insurance brokers that we cover (Aon [AOC \$40.94] and Marsh & McLennan [MMC \$22.65]) and our more-cautious view on pricing kept us from adding either of these names to our one-year list.

While commercial property-casualty insurance related-names could continue to outperform on a relative basis if equity markets do not recover in 2009, we are cautious regarding this group on a

relative basis. We hold this position because we expect disappointing earnings for the industry overall: Our underlying assumption for the financial services group is that while fundamentals will deteriorate in the near term, equity markets will begin to discount a recovery some time during 2009, leaving more defensive groups like property-casualty insurance behind on a relative basis. Consolidation activity has come to a halt since credit and financial markets collapsed starting in mid-September, but we expect activity to improve as credit markets stabilize. Increased activity could provide some valuation support, although we also see more distressed sales likely emerging from this period. Our primary concern for commercial property-casualty insurance related-names is the potential for more significant underlying margin deterioration and earnings disappointments during 2009.

#### **Stock Selection – ACE Limited (Three-to-Five-Year List)**

ACE is a specialty commercial lines property-casualty underwriter. The company also operates an emerging accident and health business (about 20% of earnings), including the recently completed acquisition of Combined Insurance from Aon. We view ACE as a best-in-class commercial property-casualty underwriter globally with good diversity and strong financial flexibility. Execution has been among the industry's best over the past few years under CEO Evan Greenberg, in our opinion.

The commercial property-casualty insurance industry has missed the major pain associated with the current credit crisis, and ACE has performed in line if not better than the overall industry during this period, in our opinion. ACE's capital position remains firmly in the range required by all principal rating agencies for its current ratings (A+ financial strength rating for ACE Group from S&P, unsecured debt rating of A3/A-), although we would expect above-average credit losses to be a modest drag on capital for the next few quarters. On October 17, Standard & Poor's reaffirmed all of ACE's counterparty credit and financial strength ratings with a stable outlook. ACE's investment portfolio is less risky than the overall insurance industry (including life insurers) and average, or slightly below average, for a commercial property-casualty underwriter, in our opinion. Total debt to total capitalization was only 17.6% as of September 30, 2008, and could move higher at the current ratings level even on a temporary basis—up to 30%, which would imply debt capacity of up to about \$3 billion, in our opinion. ACE does not issue commercial paper or any other short-term securities to finance its operations, and has no significant maturities coming due in the near term.

ACE's financial flexibility should allow the company to pursue acquisitions opportunistically and ACE could be a buyer of smaller AIG operations. We would be disappointed if ACE were to buy XL Capital (XL \$2.68) unless it was a highly attractive financial deal—strategically it offers limited benefits, in our opinion. We also believe that ACE is arguably the largest beneficiary of the competitive degradation of both AIG and XL Capital, given the large business overlap between the firms.

We view valuation reasonable and attractive on an absolute basis, but relative valuation is about average, and the shares are not nearly as inexpensive as credit-sensitive financial companies. The shares trade at 1.02 times GAAP book value per share, 0.96 times GAAP book value per share excluding OCI, and 1.36 times tangible book value per share (as of September 30, 2008). The GAAP book value should decline further in the fourth quarter, given increasing unrealized losses within the fixed income portfolio due to wider credit spreads.

#### **Custody Banks (Dave Long)**

##### **Overview**

We believe the custody banks will continue to produce above-average top-line growth for the next several years. Global secular trends continue to be favorable and are supported by rising cross-border investment, increasing savings levels, modernization of pension schemes around the world, and favorable wealth demographics. We believe the increasing complexity of investment strategies and products, and greater attention to operations infrastructure to support fund administration, performance measurement, recordkeeping, compliance, and risk management should drive more outsourcing opportunities for the custody providers.

We believe attractive revenue opportunities have been created by the recent market disruption: cost cutting by fund managers could lead to new outsourcing opportunities, new regulatory requirements could lead to additional mandates in compliance and risk management, disruption at commercial and

investment banks has led to a rapidly growing pipeline in wealth management, uncertainties in the prime brokerage business has led to an inflow of noninterest bearing deposits from hedge funds, and new business opportunities have surfaced from some of the 28 other TARP-like programs around the world.

Revenue can be volatile quarter-to-quarter, due to equity values, fund flows, cross-border flows, foreign-exchange volatility, trading activity, and interest rates. We expect operating leverage to be challenging in 2009 as the companies face difficult comparisons due to lower equity market valuations and unusually high levels of foreign exchange trading and securities lending activities in 2008.

In line with their commercial bank peers, we expect cost cutting to be a theme for 2009. Bank of New York Mellon and State Street have announced layoffs, and we expect other discretionary spending items to be closely monitored, including information technology and travel and entertainment.

Relative P/E multiples for the group have declined to levels equal to or less than the S&P 500. We attribute this to their sensitivity to the overall equity markets; as a rule of thumb, a 10% change in the global equity markets impacts revenue for the custody banks by 2%. Additionally, the custody banks have pledged roughly \$500 million each in capital support to offset potential client losses in securities lending collateral pools and registered investment funds, among other areas. Lastly, unrealized losses in investment securities portfolios have led to stress on capital levels, particularly for State Street and Bank of New York Mellon.

#### **Stock Selection – Bank of New York Mellon (Bounce-Back List)**

We have confidence in the durability of Bank of New York Mellon's business model and its ability to navigate through the challenging environment. Bank of New York's importance to the U.S. financial system was confirmed when it was included as one of the first nine financial institutions to receive funds from the U.S. Treasury through the TARP Capital Purchase Program. We expect Bank of New York Mellon to benefit from positive long-term secular trends in global custody, and we believe it will capitalize on attractive new revenue opportunities that have been created by the recent market disruption.

We view Bank of New York Mellon's stock as highly levered to an improvement in the credit markets. It had an unrealized loss within its investment securities portfolio of \$2.8 billion at September 30 and we expect this to increase at year-end 2008. However, most of this unrealized loss is simply a result of lower prices for highly-rated, AAA and AA, securities given credit market deterioration. Once the credit market pricing gains some level of rationality, Bank of New York's capital levels will rise, and we expect its stock price to follow.

We believe the shareholder risk related to the Russian lawsuit has diminished and would not be surprised to see the risk eliminated altogether in the near future. We view this as a potential catalyst for its share price as certain investors remain reluctant to hold the stock with the lawsuit still outstanding.

Its shares trade at less than 9.0 times our 2009 EPS estimate, a 20% discount to the S&P 500. We believe a premium is warranted given the durability of its business model, low level of credit risk, and attractive global growth opportunities.

We view weakness in the global equity markets and further deterioration of the credit markets as the biggest risks to our outlook for the company. Additionally, we expect foreign exchange trading and securities lending revenue to decline from unusually high levels. Despite such headwind in 2009, we believe recently announced cost-cutting measures, combined with the realization of additional synergies from the former Bank of New York and Mellon Financial merger, will produce positive operating leverage in 2009.

#### **Stock Selection – Northern Trust (One-Year List and Three-to-Five-Year List)**

Our top stock selection among the custody banks for 2009 and the next 3-5 years is Northern Trust. We view its business model (focused on two durable businesses: global custody and wealth management) as the best among its custody and regional bank peers. Additionally, it takes minimal balance sheet risk relative to its peers: it maintains a conservative lending culture, and has a lower-risk

loan portfolio with NCOs of only four basis points through September 2008; and its investment securities portfolio is treated as a liquidity portfolio, with the company maintaining a high-concentration of agency debt rather than higher-risk asset backed securities.

Growth in Northern's Corporate and Institutional Services (C&IS) business will continue to be driven by the positive secular trends in global custody, including the privatization of retirement assets, globalization of investing, and new opportunities caused by the recent market disruption. We believe growth over the next few years will be driven primarily by new opportunities in Europe. However, activity in China, Australia, and the rest of the Pacific Rim region has accelerated recently and is likely to become a larger portion of AUC growth over the next several years.

Our outlook for Northern's Personal Financial Services (PFS) business, which includes wealth management, is supported by strong demographics—growth in the millionaire population (wealth creation) and wealth transfer (driving demand for fiduciary services). We expect an unusually strong inflow of new business in its PFS business, including wealth management, over the next few quarters as certain competitors deal with tax-related law suits, M&A activity, and/or concerns with capital levels.

Its shares trade at 11.5 times our 2009 EPS estimate, a 2% premium to the S&P 500 versus an average premium of more than 15% premium over the last several years; we view Northern as a safer investment within financial services with less headline risk, but believe that it will also participate in a financial services recovery.

We view weakness in the global equity markets as the biggest risk to our EPS estimates for Northern. Additionally, we expect foreign-exchange trading revenue to decline from unusually high levels. Despite more closely monitoring discretionary spending in this challenging environment, we believe the company will not be able to produce positive operating leverage in 2009, due to the headwinds created by lower equity market valuations and normalization of foreign-exchange trading revenue.

## **Exchanges (Mark Lane)**

### **Overview**

Volume growth has slowed meaningfully given the intensity of market dislocation, including heightened volatility and limited liquidity, tighter credit, reduced risk-taking, and the breakdown of traditional asset correlations. The weakness has been pronounced in the futures exchanges we cover, particularly the interest rate business (CME's interest rate volume was down over 50% in November 2008 compared to November 2007), although growth has slowed in all futures asset classes, including commodities. Visibility remains limited in the near term, and we assume the lull in growth continues for at least the next few quarters, with futures industry volume in the aggregate down 5% to 15% in 2009. Credit markets need to stabilize and commodity prices need to re-inflate for volume growth to improve more broadly, in our opinion.

While near-term challenges are clearly present, we believe the development of global capital markets over the long term will continue to drive above-average long-term growth for the exchanges—faster growth for derivatives. The financial characteristics of the exchanges also remain among the best, if not the best, within financial services. Exchanges are cash businesses with high margins and high returns, have minimal balance sheet risk, and no funding needs. Barriers to entry are also high.

All exchanges should benefit generally from increasing demand for more transparency and the demand for reducing counterparty credit risk through centralized clearing. Moving OTC markets toward centralized clearing should also help growth of exchange traded markets. CDS clearing is an opportunity for certain exchanges that own clearing organizations, but the economic benefits are unclear at this time and likely to be compressed given competition and dealers' desire to be involved in execution. We view the IntercontinentalExchange as the biggest winner to start because its clearing organization has won support of the dealers and its interdealer CDS broker, Creditex, should gain share and benefit from the expansion of the overall market over the long term.

While M&A has slowed for all sectors within the economy, we expect consolidation to re-emerge as markets stabilize. We also expect to see more business relationships develop between U.S. and other

international exchanges, and actual combinations develop as markets deregulate more meaningfully. We view CME Group, The NASDAQ OMX Group, NYSE Euronext, and Deutsche Boerse as the key global consolidators—the IntercontinentalExchange could go either way, in our view.

Valuations levels have collapsed, declining over 60% over the past 12 months, given concerns about volume growth coupled with a high P/E multiple group. We view valuation as reasonable over any longer time period with a 15-to-20-times forward-12-month P/E achievable for the futures exchanges, as markets stabilize and volume levels bottom, given the favorable long-term growth opportunities and competitive and financial characteristics of the exchange space.

Our key near-term concern is limited near-term visibility for volume growth. We also believe the industry is likely to face regulatory changes over time, but major changes in 2009 do not seem necessary, given other pressing, legislative and regulatory priorities, in our opinion. With CDS moving toward centralized clearing and other groups targeting entrance into the futures space, competitive concerns should linger.

#### **Stock Selection – CME Group (Three-to-Five-Year List)**

CME is the world's largest and most-diverse futures exchange: interest rates 46%, equities 25%, foreign exchange 6%, commodities/other 23% based upon volume; rates 30%, equities 22%, foreign exchange 7%, commodities/other 41% based upon transaction fees (as of third quarter 2008). In November 2008, 84% of volume was traded electronically.

CME is well diversified by asset class, but still tied to the futures market. While the company faces some near-term cyclical pressure, we believe the futures market remains a growth market over the long term, although the key growth for the next five years will not match the power of the key growth drivers over the past five years (shift to electronic trading, growth of alternative asset management, easy credit, etc.). Importantly, we view all of the exchanges as beneficiaries of the general increasing demand for more transparency and the demand to eliminate counterparty credit risk through centrally cleared trading.

Futures exchanges still remain among most attractive business models within financial services and CME's financial characteristics stand out in current markets. It is a cash business, has minimal balance sheet risk and credit risk, and is a self-funding business. Given the favorable competitive characteristics of the business and the high fixed cost component of the business model, consolidation adds significant strategic and financial benefits, and we believe the CME will remain an important consolidator in the space. We believe it is only a matter of time before CME diversifies in a major way beyond the futures market and/or overseas.

We continue to believe CME's competitor ICE as the best positioned among the exchanges to initially capture significant market share in the U.S. CDS market as the market moves toward centralized clearing in the very near term. However, over time market share may shift depending on product and market developments, and CME may capture some market share especially if there is a preference for a separately capitalized clearinghouse. We expect the regulatory structure for the centralized clearing of CDS contracts to be clarified in the near term (hopefully before year-end) and approval granted by the appropriate regulator to certain participants with centralized clearing solutions.

The shares trade at a much more reasonable 13.1 times our Street-low \$16.00 estimate for 2009, the P/E multiple down more than 60% over the prior 12 months, given concerns about the durability of growth in combination with a significant premium valuation. Our primary near-term concern is the depth and duration of the current volume slowdown. We also believe regulatory changes are likely to be meaningful over the next few years, with both negative and positive implications for the futures exchanges. We also believe CME has made large strategic mistakes while attempting to penetrate the large OTC market over the past few years.

#### **Stock Selection – IntercontinentalExchange (One-Year List)**

ICE pioneered the electronic trading of energy futures globally and the electronic trading of OTC energy derivatives in the United States. ICE is among the fastest-growing global exchanges of any size, and we view it as one of the more dynamic growth companies within financial services. We believe electronic energy derivatives trading is still developing on a global basis, particularly within the

OTC markets, and ICE has well proved its ability to extend its franchise beyond energy markets, in our opinion. The company's transaction fee revenue is split 36% OTC electronic energy trading, 24% electronic energy futures, 11% soft-commodities, 23% credit brokerage, and 6% financial futures (2009 estimate).

While not immune from market challenges, ICE stands out in 2009 given its EPS growth visibility, particularly compared to the CME Group. ICE is one of only a few companies in our coverage universe that should post EPS growth. ICE's move to self-clearing in November 2008, the exclusive launch of the Russell equity index futures in September 2008, and the acquisition of Creditex in August 2008 should contribute greater than 100% of EPS growth in 2009. Our underlying volume growth assumption is a 5% to 10% decline excluding financial futures.

ICE's financial characteristics also stand out in current markets. The exchange business is a cash business, has minimal balance sheet risk and credit risk, and has no funding needs. Importantly, exchange listed and cleared OTC derivatives are even more attractive in this environment, given higher transparency and the elimination of counterparty credit risk through centralized clearing.

We also believe ICE is best positioned initially to benefit from the move to centralized clearing for CDS in the United States. ICE has gained the support of nine major dealers that control the vast majority of the CDS market in the United States. We expect regulatory approval soon and a gradual ramp in business during 2009. We have no financial benefit within our estimates, because the economics of the opportunity are unclear and we expect the business to gradually ramp during 2009. We do believe there could be an opportunity for other clearing organizations to take share for CDS clearing.

The entry point is not perfect, with the stock up 64% from its recent intraday low, but remains very reasonable at 14.5 times our 2009 EPS estimate of \$5.30—a more-than-60% decline over the past 12 months. Our key near-term concern include fading near-term volume growth for energy derivatives given the significance of the drop in commodity prices including energy. We believe re-inflation of commodities prices at some point would bring more trading activity including hedging. Regulatory changes and legislation also remain key areas to watch, and we believe that the financial contribution from CDS could be somewhat slower to develop in 2009 than generally expected.

## **Payment Card Networks (Dave Long)**

### **Overview**

We believe payment card volume is poised for attractive long-term growth, due to the continued move toward card-based payments, the development of new payment solutions and categories, the modernization of payment infrastructures within developing nations, and the increase in cross-border travel. We expect card volume growth to continue to take market share from paper-based payment forms worldwide. In the United States, we believe the market share of card-based payment transactions could reach 55% of consumer payments volume by 2012, up from 42% in 2007. Outside the U.S., card-based volume represents less than 20% of total payment volume.

Despite a slowdown in payment card volume growth in 2009, we forecast mid-to-upper-teens EPS growth for the payment card networks (Visa and MasterCard [MA \$138.81]), as certain discretionary expenses can be rationalized, particularly marketing, consulting, research and development, and travel and entertainment.

The payment card networks do not extend credit, issue cards, or determine fees or interest rates charged to cardholders. While rising credit costs and poor investment decisions are creating near-term headwind for many large-cap financial institutions, Visa and MasterCard continue to produce attractive growth and improve operating margins. The economics of the payment card network business are among the best in financial services, in our view. Business attractions include pricing power, relatively small capital requirements, strong cash flow, increasing operating margins, and long-term EPS growth of at least 20%.

Visa and MasterCard's shares have declined 40% and 55%, respectively, from their highs. We attribute the decline to a slowdown in volume growth and the strengthening dollar, which have reduced

revenue growth expectations. We believe their shares deserve to trade at a premium to our 3-5 year EPS growth forecasts of at least 20% due to attractive global growth opportunities, predictability of earnings, no credit risk, and significant operating leverage.

#### **Stock Selection – Visa (One-Year List and Three-to-Five-Year List)**

Our top stock selection among the payment card networks for 2009 and the next 3-5 years is Visa. Despite slower volume growth in 2009 due to the global recession, Visa should post relatively strong results in 2009—at least midteens EPS growth driven by near double-digit revenue growth, expense rationalization, expanding operating margins, and share repurchases. Additionally, Visa carries no credit risk, as it is not a lender, and it has a strong balance sheet: \$21.5 billion in common equity and only \$100 million in debt. We believe it is likely to repurchase a substantial amount of its shares in 2009.

Visa's high concentration of debit cards insulates it somewhat from the global recession and more so than its closest competitor, MasterCard. Visa has a 2.6-to-1 lead in U.S. debit and 3-to-1 lead outside the U.S. over MasterCard. Debit transactions are more closely aligned with non-discretionary purchases. In October, debit card volume growth remained near double digits, while credit card volume declined.

Long term, the company will be the primary beneficiary of strong secular growth, including the conversion of check and cash-based transactions to card-based transactions. Visa has helped create more than a dozen new categories for card use over the last few years, including quick-service restaurants, utilities, taxicabs, transit, and parking.

Visa's shares trade at 19 times our calendar 2009 EPS estimate (\$2.71), a discount to our five-year estimated annual EPS growth rate of 21%. We believe a premium to its growth rate is warranted given its unique global growth opportunities, its expanding operating margin and no credit exposure.

While we believe Visa is more insulated from the effects of deteriorating economic conditions, it is not immune from the global economic recession. We forecast declining volume growth for the next several quarters, and growth could remain in the single-digits through 2010, depending on the severity of the current recession.

#### **Specialty Finance (Dave Long)**

##### **Overview**

Credit quality has deteriorated across the board for lenders, and we expect credit costs to continue to rise for most specialty finance companies in 2009. We believe the extent of credit deterioration is uncertain, and therefore, have a low level of confidence in EPS estimates for most specialty finance companies. EPS estimates have declined throughout the year and may still be too high for several consumer-oriented finance companies. As a result, shares of specialty finance companies have declined more than 50%, on average, in 2008.

The business models for certain specialty finance companies have become challenged and some companies are likely to emerge from the current credit market and economic disruption in a different form. Those companies that have relied on the capital markets for funding have begun to search for alternative funding sources, focusing mostly on deposit gathering. Specifically, Capital One (COF \$28.12) has acquired three banks over the last three years, Sallie Mae (SLM \$8.29) started offering brokered deposits to fund private loan growth, and NewStar Financial (NEWS \$2.99) applied to become a bank holding company earlier this month.

Loan origination volume is expected to slow across specialty finance segments. Credit card issuers have reduced credit limits and reduced balance transfer offers as the health of the consumer deteriorates. The economics of the student lending business have declined: cut in federal subsidies, higher funding costs, credit market disruption, rising credit costs, and widening of 3-month commercial paper/LIBOR spread. FFELP lending remains robust, but the origination of private loans has slowed due to challenges funding such growth. In leveraged finance origination activity has slowed; however,

terms—higher spreads and lower leverage (debt-to-EBITDA)—remain favorable for those with origination platforms and funding.

We believe consumer NCOs will be substantially higher than the last recession earlier this decade as the consumer back then had several liquidity options stemming from rising home prices and easy credit, which is in contrast to the backdrop today.

Additional information is available upon request.

**Current Rating Distribution (as of 11/30/08)**

<b>Coverage Universe</b>	<b>Percent</b>	<b>Inv. Banking Relationships*</b>	<b>Percent</b>
Outperform (Buy)	55	Outperform (Buy)	4
Market Perform (Hold)	44	Market Perform (Hold)	2
Underperform (Sell)	1	Underperform (Sell)	1

\*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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William Blair & Company, L.L.C. 222 West Adams Street Chicago, Illinois 60606 312.236.1600 [www.williamblair.com](http://www.williamblair.com)

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