



TRINITY SMF

STUDENT MANAGED FUND

Financial Non-Banks Sector Report 2023-2024

Sector Manager
Aidan Lavery

Senior Analyst
Maria Bohan



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The Non-Bank Financial Intermediation (NBF) ecosystem encompasses a wide range of financial activities, entities, and infrastructure. Non-Bank Financial Institutions (NBFIs), which include investment funds, insurance companies, pension funds, and other intermediaries, exhibit varying business models, balance sheets, and governance setups, and can be subject to distinct regulatory frameworks within and across jurisdictions. These institutions are gaining prominence in funding the real economy and overseeing household and corporate savings. Serving as a vital alternative to traditional banking, they contribute significantly to driving real economic growth.

The sector is cyclical due to its elasticity of demand (i.e., fluctuations in demand are greater relative to non-cyclical sectors). Cyclical sectors, such as financials services and luxury goods depend highly on the economic cycle, as people are less likely to invest their finite money in non-necessities when disposable income is scarce. If the economy grows, cyclical stocks typically benefit. If the economy goes into recession, cyclical stocks often fall sharply. However, it is worth noting that, although the financials industry as a whole is cyclical, some NBFIs are more receptive to the economic cycle than others.

MSCI World Financials Index Cumulative Index Performance (Net Returns in USD)



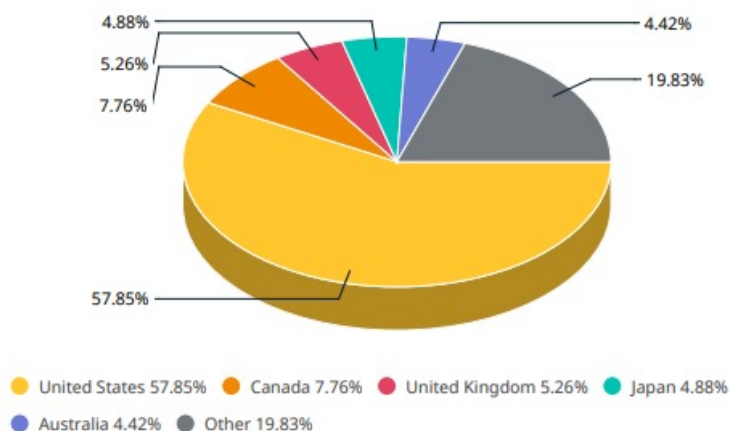
Year	MSCI World Financials	MSCI World
2022	-10.19	-18.14
2021	27.87	21.82
2020	-2.84	15.9
2019	25.51	27.67
2018	-16.97	-8.71
2017	22.74	22.4
2016	12.47	7.51
2015	-3.37	-0.087
2014	3.17	4.94
2013	27.33	26.68
2012	29.36	15.83
2011	-18.49	-5.54
2010	4.61	11.76
2009	31.08	29.9

The MSCI World Financials Index illustrates that the Financials sector has provided mostly consistent growth since 2009, with the US accounting for a majority of the sector. It includes 240 constituents, the top 3 being JP Morgan Chase & Co, Berkshire Hathaway B, and Visa A. The sector has increased 8.85% YTD as the global economy seeks to bounce back from the challenges of navigating record-high levels of inflation; with the US Consumer Price Index (CPI) reaching 7.7%, UK CPI reaching 11.1%, and the EU CPI reaching 10.6%, in 2022. The resurgence of the sector has been largely due to a withdrawal from these heights of inflation, a retraction back to the current levels of 6.8% in the UK as of August 2023. This negative correlation between the sector and inflation is due to heightened inflation causing increased credit risk, increased operational costs, as well as subsector impacts, such as increased costs of claims in the insurance subsector as prices of labour and assets increase with inflation.

Sector Overview - Subsectors




Country Weights



The Financials Sector is primarily led by the United States, with supplementary countries such as Canada, the UK, Japan, and Australia making comparable contributions as secondary players. The remaining global share constitutes less than a fifth of the Financials Sector. It is important to note, however, that this jurisdictional breakdown includes the contributions of both Banks and NBFIs.

Top Constituents of Index

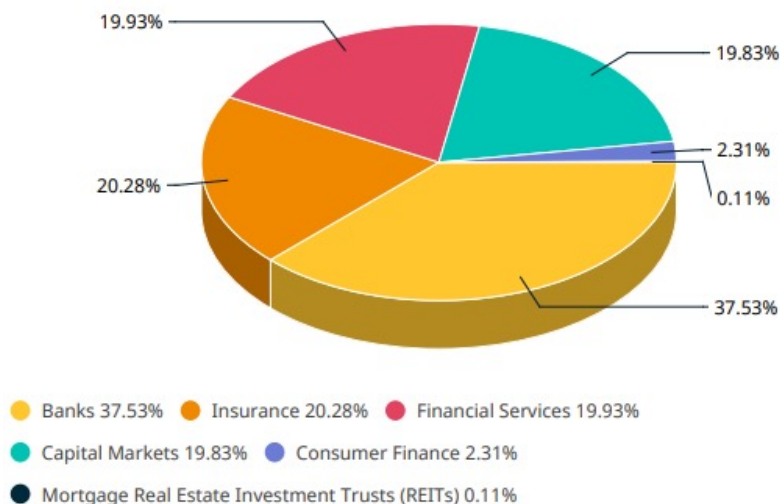
Name	Ticker	Country	Industry	Float Adjusted Market Cap (billions)	52-Week Range	P/E	Index Weight (%)
BERKSHIRE HATHAWAY INC.	BRK.B	US	Capital Markets	\$456.91	\$259.85 - \$364.63	104.12	5.23
VISA	V	US	Financial Services	\$386.3	\$174.6 - \$245.37	30.23	4.42
	MA	US	Financial Services	\$335.59	\$276.87 - \$405.19	36.95	3.84
S&P Global	SPGI	US	Financial Analytics	\$129.28	\$279.32 - \$428.65	53.42	1.48

Prominent Non-Bank constituents within the Financials Sector include Berkshire Hathaway B, Visa A, Mastercard A and S&P Global. These companies exert significant influence on the MSCI World Financials Index, constituting weightings of 5.23%, 4.42%, 3.84% and 1.48% respectively.

Stock performance metrics are crucial when assessing investment opportunities. The 52-week range represents the lowest and highest prices at which it has traded over the past year. In the case of Berkshire Hathaway B (BRK.B), its 52-week range spans from \$259.85 to \$364.62. This range provides investors with insights into the stock's price volatility and the price levels at which it has found support or resistance. Additionally, the Price-to-Earnings (P/E) ratio measures the relationship between a stock's current price and its earnings per share. BRK.B's P/E ratio is 104.12, indicating that investors are willing to pay \$104.12 for every dollar of earnings generated. This metric shows how the market values a stock relative to its earnings potential. A high P/E ratio, like BRK.B, may suggest higher growth expectations or investor confidence in the company's future prospects.



Sub-Industry Weights



Sub-Industries, Key Performance Indicators (KPIs) and Growth Drivers

Insurance

The primary role of the insurance industry is to provide individuals and businesses with protection against an array of potential risks. This protection is funded through premiums collected from policyholders, enabling them to secure coverage for potential losses and damages. Additionally, premiums are invested to provide a return that matches or surpasses claim receipts.

To evaluate the performance of companies in this subsector, Key Performance Indicators (KPIs) play a pivotal role. These KPIs encompass various metrics such as the loss ratio, premium growth, underwriting profit margin, return on equity (ROE), investment income, retention rate, expense ratio, solvency ratio, claims processing time and net promoter score (NPS).

The expansion of the insurance subsector is propelled by a mix of significant factors. Robust economic growth drives the demand for insurance, as individuals and businesses seek to safeguard their assets from potential uncertainties. Likewise, population growth and urbanisation lead to increased needs for insurance coverage, spanning properties, vehicles, health, and more. Evolving regulations and technological advancements create an environment conducive to market growth and improved services. Venturing into emerging markets brings opportunities, driven by tailored consumer preferences and innovative insurance products. The rise of challenges like cyber risks and climate change underscores the importance of specialised insurance solutions. Globalisation, coupled with aging demographics, healthcare cost escalation, and the increased occurrence of natural disasters, collectively shape the changing landscape of the insurance industry. These drivers collectively fuel sector expansion, influencing both traditional insurance paradigms and the development of new products that align with emerging needs.



Financial Services

The financial services industry operates as a pivotal role in bolstering global economic efficiency through a wide range of financial offerings. Examples of financial services includes; Asset Management, Payment Processing, Financial Analytics etc. This diverse suite of services is designed to optimise financial resources, facilitating the smooth movement of capital among stakeholders. Financial services companies generate revenue through a combination of fee-based services like account management and financial advisory, interest earnings from lending, and investment gains.

KPIs pertinent to this subsector include Assets Under Management (AUM), Return on Assets (ROA), Cost-to-Income Ratio, Client Retention Rate, Fee Income Percentage, Net Promoter Score (NPS), Digital Adoption Rate and Regulatory Compliance.

The growth of the financial services subsector is fuelled by a combination of influential drivers. Technological advancements, particularly in fintech, enhance efficiency and accessibility, broadening the scope of financial services and attracting a diverse clientele. On the global stage, the rise in cross-border transactions and trade drives the expansion of sophisticated financial services, sparking growth in segments like international banking and trade finance. Simultaneously, as economies grow, the need for an expanded range of financial services becomes apparent, including investment management, insurance, wealth management, and retirement planning. Demographic shifts, the pursuit of sustainable finance, urbanisation dynamics and the ascent of digital payments converge as transformative catalysts, further propelling this subsector's expansion.

Capital Markets

The capital markets industry holds a pivotal role within the sphere of NBFIs, facilitating the issuance, trading, and exchange of various financial instruments like stocks, bonds, commodities, and derivatives. These markets are a vital channel for corporations and governments to raise funds by offering securities to investors. This dynamic ecosystem functions as a platform where ownership of financial assets shifts between buyers and sellers. It is important to note, economic conditions such as changes in interest rates, inflation, and geopolitical events can significantly alter trading dynamics by influencing investor sentiment and asset valuations.

Revenue in this industry comes from several sources. Notably, transaction fees and commissions earned from facilitating trades and transactions on platforms form a key revenue stream. These fees often depend on the volume or value of transactions. Additionally, companies may provide advisory services to clients, furnishing expert insights for investment decisions and earning fees for their expertise. Moreover, insights derived from trading activities can be valuable, allowing firms to offer investors market analysis and intelligence for a fee.

A comprehensive assessment of industry performance relies on Key Performance Indicators (KPIs). These include metrics like trading volume, market share, revenue growth, average transaction value, customer acquisition and retention, advisory fee income, underwriting fees, market data and



analytics revenue, operational efficiency, technology adoption and innovation, regulatory compliance, and liquidity management.

The growth trajectory of the capital markets subsector is intrinsically linked to key drivers. Technological advancements underpin its expansion by improving trading platforms, enabling algorithmic trading, and broadening market access. Globalisation amplifies its influence, drawing in international investors and diversifying trading opportunities. Economic conditions significantly shape trading dynamics and the issuance of new securities. Meanwhile, regulatory changes have the potential to reshape the industry landscape, fostering innovation while upholding market integrity. Evolving investor preferences, exemplified by the rise of sustainable finance and ESG investing, mould the demand for specific financial instruments. As financial markets become more interconnected, macroeconomic trends and geopolitical events exert a notable impact on the growth of the capital markets subsector.

Consumer Finance

The consumer finance industry offers a diverse range of customised financial products and services to individual consumers. These companies specialise in providing credit, loans, and payment solutions that empower individuals to make purchases, manage their finances, and achieve their personal and financial goals.

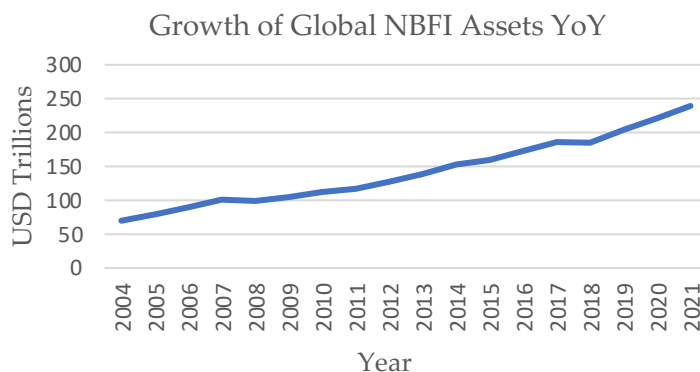
These companies generate revenue through various channels. Revenue is primarily earned from interest on loans and credit extended to consumers. Additionally, fees related to loan origination, late payments, or credit card memberships contribute to revenue streams. Collaborations with retailers provide another income source, with companies earning a share of sales generated through retail financing programs.

To gauge company performance within this subsector, KPIs play a crucial role. These encompass loan portfolio quality, net interest margin, loan origination volume, loan delinquency and default rates, customer retention rate, average loan size, cost-to-income ratio, digital adoption rate and regulatory compliance metrics.

The expansion of the consumer finance subsector is fuelled by several driving forces. Evolving consumer preferences, marked by a demand for accessible financial services, propel growth. Technological innovations enable companies to offer seamless digital solutions, enhancing customer experiences and streamlining processes. Regulatory shifts play a crucial role in shaping industry operations and maintaining consumer protection standards. Economic conditions, including interest rate trends and overall economic health, significantly influence borrowing behaviour and credit demand. Furthermore, demographic changes, such as shifts in population growth and generational preferences, impact the demand for specific financial products and services. Amid these dynamics, the consumer finance subsector continues to adapt, asserting its indispensable role in addressing individual financial needs and aspirations within the broader landscape of NBFIs.



In recent years, the global economy has been hit by a series of unprecedented shocks including a pandemic, the outbreak of war, and an energy crisis. As geopolitical tensions escalate, the likelihood of more frequent shocks grows. The prospect of an increasingly shock-prone economy highlights the critical need for a resilient financial sector capable of navigating emerging challenges effectively.



As revealed in the Financial Stability Board's 2022 Global Monitoring Report on Non-Bank Financial Intermediation, the cumulative global financial assets of the NBFi sector experienced a robust 8.9% growth in 2021; surpassing the five-year average expansion rate of 6.6%. With the expansion of NBFIs, new risks and vulnerabilities arise. Firstly, the robust growth of this sector, notably in asset management over the past 15 years, has led to increased liquidity mismatches. Secondly, NBFIs are intertwined with financial leverage (use of borrowed funds to amplify returns from an investment) and synthetic leverage, which can amplify shocks and create spillover risks for banks. A case in point is Archegos Capital Management, which defaulted on its losses from leveraged equity trades in March 2021. Thirdly, another vulnerability in the NBFi sector is the inadequate readiness to address substantial liquidity demands, particularly during events like margin calls; underscored by the recent stress episode in the UK pension fund sector.

Despite the emergence of new risks and vulnerabilities, the NBFi sector has demonstrated relative stability in recent months, amidst the stresses faced by the banking sector in March. Funds investors have adjusted their portfolios, shifting from higher-risk options like high-yield corporate bonds, to lower-risk assets, such as government bonds. Portfolio de-risking has also been evident in insurance corporations and pension funds, as higher interest rates have reduced incentives to chase yield.

Nevertheless, the NBFi remains particularly exposed to asset price corrections and credit risk. In addition, NBFIs' exposure to property markets has increased significantly in recent years, rendering institutions vulnerable to ongoing price corrections in real estate markets. Consequently, fragile risk sentiment and elevated vulnerabilities in parts of the NBFi sector could amplify adverse shocks.

In summary, the growing significance of NBFIs in financing the economy has become evident. This trend is positive for enhancing financial integration and fostering economic growth. However, it also introduces heightened risks to the financial system. Notably, the strong interconnection between traditional banking and the NBFi sector heightens the potential for contagion and underscores the need for vigilant risk management.



Inflationary Pressures and Insurance

Historically, persistent high inflation has constituted an adverse factor for insurance companies, a substantial segment within the NBFIs sector. Therefore, it is imperative for investors to be wary of shifting trends and overarching market sentiment. Recent rates of record-high inflation and the ensuing cost-of-living predicament stand as the paramount challenges confronting the insurance industry. Against a backdrop of heightened financial constraints on consumers, insurers may find it necessary to adopt heightened flexibility and innovation to retain their clientele.

Inflation, presenting a multifaceted challenge, wields a substantial risk for insurers. On one hand, insurers encounter the inflationary burden in operating expenses, while on the other hand, claim costs surge in tandem with the escalated prices of assets and labour. Ordinarily, insurers would defray these amplified claim costs onto customers via increased premiums. However, the present cost-of-living crisis has curtailed customers' disposable income, as surging expenditures outpace wage growth, impeding their capacity to absorb higher premium costs. Consequently, insurers confront the intricate task of balancing premium rate hikes with attracting and retaining customers.

Amidst this backdrop, insurance companies that offer distinctive value propositions stand poised for superior performance, attracting new business during discerning customer demand. Premium pricing recalibrations, policy repackaging, and strategic diversification emerge as three pivotal tools to aid insurance enterprises during this juncture. Such measures might encompass heightened customer flexibility, including options for switching coverage on and off, pay-per-mile arrangements, or even payment deferrals, akin to those witnessed during the COVID-19 pandemic. An example of an insurer who has undertaken measures to offer this value proposition is Laya Healthcare Insurance Group; offering customers flexibility to switch between plans or temporarily cease coverage without penalty to attract and retain customers during current economic distress.

The Ongoing Evolution of AI

Swift technological progress and evolving consumer preferences are propelling the ascent of non-bank players, particularly Fintech companies; notably underscored by recent strides in artificial intelligence (AI) technologies. AI is harnessed to automate operations, enrich customer experiences via chatbots, and enhance risk assessment models. Blockchain technology, meanwhile, is revolutionising sectors such as remittances and cross-border payments, ensuring secure, transparent, and efficient transactions. AI has been leveraged by companies such as Blackrock with their cutting-edge 'Aladdin' technology. Aladdin, which stands for Asset, Liability, Debt, and Derivative Investment Network, is a comprehensive investment management platform that combines sophisticated risk analytics with portfolio management, trading, and operations tools. This innovative technology has streamlined the investment process and improve operational efficiency.

These technological advancements elevate operational success and fosters consumer confidence in NBFIs. This, in turn, spurs increased investment and augments overall satisfaction within the sector.

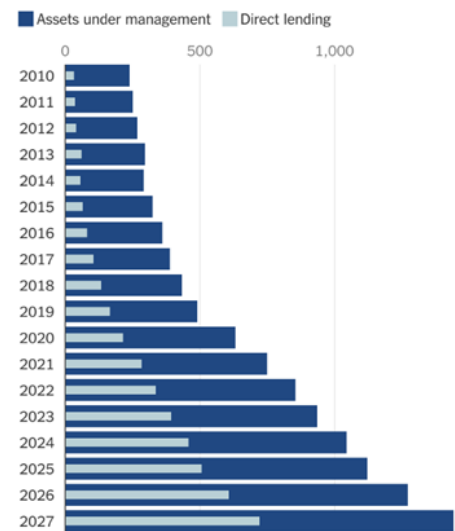


The Rise of ‘Shadow Banking’

The term “Shadow Banking” encompasses a diverse range of financial institutions that, among other functions, issue money-like instruments and extend loans. Despite not facing the same level of scrutiny as traditional banks, these entities are not immune to financial panics.

Following a decade lull, the resurgence of shadow banking is evident. Private credit extended to high-risk companies now surpasses the \$2 trillion mark, with recent historic private lending growing consistently in North America. Borrowers turn to private credit when lending gets tighter from banks because private credit providers often have more flexible lending criteria and can offer alternative financing solutions outside the traditional banking system. Analysts project continued growth over the short-medium term, as depicted by the graphic (right). The recent wave of bank failures in the United States has expedited the migration towards these less-regulated financial channels. In March, over \$400 billion in deposits exited the banking system, while more than \$300 billion flowed into money-market mutual funds. These funds experienced their sharpest growth since March 2020, when the COVID-19 pandemic prompted a rush towards cash-equivalent instruments.

Direct private lending growth in North America



Figures in \$ billion. 2022-2027 are forecasts.

Nigel Terrington, the CEO of Paragon Bank, noted that "Shadow banks tend to play on the risky edge of credit markets as they exploit regulatory differences. With [regulatory] requirements about to get tougher on banks, this situation will only get worse."

However, in certain aspects, shadow banking is typically more resilient than it was during the 2008 financial crisis. Money-market funds have allocated their assets primarily to Treasuries and the Federal Reserve, steering away from the riskier corporate paper they previously favoured. Private credit providers typically rely significantly on long-term investors, such as pension funds and insurers, for funding, potentially enhancing their capacity to absorb losses and reduce susceptibility to runs.

Nevertheless, vulnerabilities persist. A surge in popularity of money-market funds could deplete the banking system of liquidity, potentially triggering a credit crunch. Moreover, the vast holdings of US Treasury bills by these funds could present challenges if investor confidence is shaken by the federal debt-ceiling standoff. Economic downturns bring additional complexities; an increase in mortgage delinquencies could strain the finances of NBFIs managing payments for over half of all federally backed loans. Escalating defaults could destabilise private lenders. This warrants vigilance, as these institutions, unlike traditional banks, operate with a degree of regulatory flexibility that enhances their operational manoeuvrability, but concurrently exposes them to heightened risk.



Transition Towards Green Finance

The NBFIs sector is embracing green finance and a more sustainable, climate-neutral economy. With the United Nations setting ambitious goals for global net-zero emissions by 2050, customers are increasingly mindful of their carbon footprint and seeking out companies committed to sustainable development.

In response, FinTech companies are reassessing their environmental impact, investing in green innovations, and creating services to assist other companies in reducing their carbon footprint. Recent studies highlight how a company's dedication to Environmental, Social, and Governance (ESG) principles can influence risk management and returns. Companies like Patch, Capture, and Wren are simplifying the process for users to comprehend their environmental impact and take action. Payment providers, neobanks (banks that operate exclusively using online banking without traditional physical branch networks), logistics firms, and others are likely to integrate options for carbon offsetting into their products. This embrace of green finance is anticipated to unlock substantial growth opportunities for both emerging and established companies.

Regulation Changes

The regulatory landscape stands as a significant determinant impacting the functions of NBFIs. Unlike conventional banks, these entities enjoy a measure of flexibility due to less stringent regulatory frameworks. However, this paradigm could potentially undergo transformation as the Financial Stability Board (FSB) shifts its focus toward enhanced regulation within this sector. The FSB has recently introduced recommendations concerning the regulation, supervision and oversight of crypto-assets, markets and global stablecoin arrangements.

In jurisdictions where robust regulations are lacking, NBFIs have the potential to amplify the vulnerability of the financial system. Consequently, the augmenting regulatory framework will prove advantageous to developing nations and emerging markets. While it's important to note that not all NBFIs are lightly regulated, those constituting the shadow banking system often are. Preceding the global financial crisis, regulators primarily focused NBFIs supervision on pension funds and insurance companies, largely overlooking institutions like hedge funds and structured investment vehicles. If a substantial portion of the financial landscape is composed of NBFIs operating with minimal regulatory oversight, the overall stability of the system could be jeopardised.

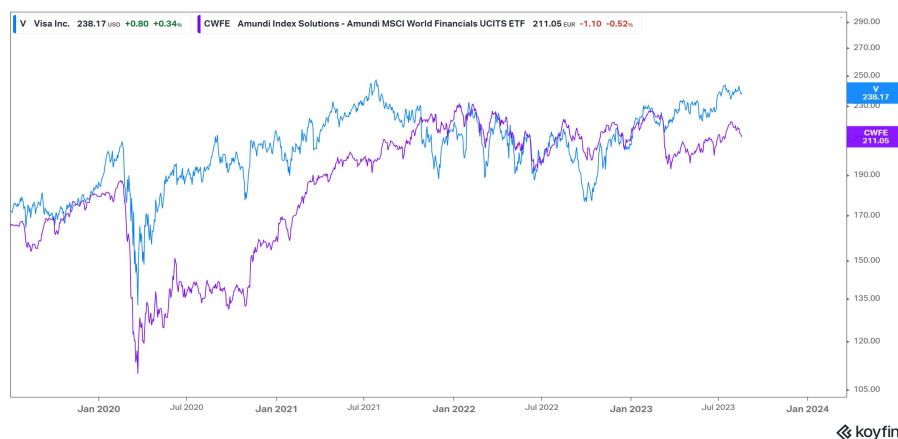
Gaps in NBFIs regulation can contribute to the formation of credit bubbles and the overvaluation of assets, ultimately culminating in asset price collapses and loan defaults. Thus, while heightened regulation in the NBFIs sector might initially curtail operational flexibility, it stands to mitigate the potential systemic risk associated with investments in the sector.



Company Overview

Visa Inc (Visa) is a global digital payment technology company that serves individual and commercial clients, financial institutions, government entities, and merchants. It facilitates global e-commerce through digital payments and information. Visa’s transaction processing network, VisaNet, conducts clearing, authorisation, and settlement of payment transactions. The company also routes payment information and related data. Its portfolio of offerings consists of mobile payments, payment cards, commercial payments, transaction processing services, merchant solutions, and other digital services. Visa commands a global market share of 40%, while in the US it is over 50%. Visa’s largest competitor in the US and Europe is Mastercard, while Unionpay is its largest Chinese rival.

Stock Performance



Metric	August 2020	August 2023
Stock Price	204.13	241.53
Earnings Per Share (Trailing 12 Months)	\$4.38	\$7.03
Dividend Yield	0.59%	0.75%

Investment Details

Price Bought:
\$212.06 (€200.79)
Return to Date:
10%

Stock Strengths

Duopoly

Visa holds a dominant position in the global credit and debit card market alongside Mastercard. It operates as a transaction facilitator, avoiding credit risk. Visa capitalises on strong network incentives, as consumers require widely accepted cards and merchants predominantly accept Visa and Mastercard. This interdependence drives its success. Merchant fees, shared among issuing and acquiring banks, card schemes, and intermediaries, provide revenue. Issuing banks benefit most, receiving 50 to 90% of fees, enabling them to offer consumer rewards.

Scale, Margins and Share Buybacks

Visa uses its scale effectively, yielding strong operational leverage. Despite its modest portion of merchant fees (0.14%), the substantial transaction volumes (\$11.6 trillion in 2022) generate vast revenue. This high volume and scale drive wide margins, which have steadily improved with business growth. Over the last decade, the operating margin increased from 61% to 67%, net income margin from 42% to 50%, and free cash flow margin exceeded 50%. This solid free cash flow margin enabled share buybacks totalling 20% and consecutive annual dividend increases since its IPO. Notably, these actions resulted in a 275% EPS increase and 200% net income growth over the past ten years.



Tailwinds

Transition from Cash

While cash remains prevalent for numerous transactions worldwide, cashless transactions have surpassed cash in total value. Consumers from more economically developed countries have adopted cashless transactions more eagerly; with the majority of economically active people in the UK, US, France, China etc. preferring cashless transactions. This is a tailwind for Visa as the developed world increasingly moves towards digital transactions, driving demand for their services. It also comes as less economically developed countries, such as the Philippines, have only 33% of people preferring cashless transactions, showcasing the attainable markets for Visa to expand into.

The Increased Use of Credit

Recent reports by Technavio indicate that global credit card payments are projected to sustain an annual growth rate of 7.36% until at least 2026. This upward trend in credit card payments directly correlates with higher payment facilitation fees, contributing to Visa's revenue stream.

Economic and Commercial Growth

Global economic and commercial expansion has remained steady and is anticipated to maintain a long-term upward trajectory. With its involvement in both e-commerce and in-person transactions, Visa is strategically positioned to capitalise on this enduring trend.

Stock Performance

Stock performance has increased by 16.83% in the year to date (YTD) (from \$207.39 on 01/01/2023 to \$242.30 on 24/08/2023). Recently, Visa was also boosted by a expectations-beating Q3 performance; reporting earnings of \$2.16 per share and revenues amounting to \$8.12 million, a 12% advance of the previous third quarter in the year prior. This will fill investors with confidence in Visa and its management.

Enticing Opportunities

Visa has established a range of partner programs in emerging industries such as FinTech, Crypto and Content Creators. For instance, its venture with Airwallex, facilitating efficient cross-border payments. This diversification allows Visa to establish a foothold in emerging sectors. Additionally, Visa is strategically positioned to tap into emerging markets where credit and debit card usage is in its infancy, yet rising disposable income presents an optimistic outlook for future growth.



Headwinds

Lack of Brand Loyalty

Visa's lack of distinct product differentiation becomes evident in its transactions, where customers prioritise smooth processing over brand allegiance. The discernible disparity between payments processed by Visa or Mastercard is minimal, with users seeking functional reliability. This dynamic highlights an opportunity for disruptive players to gain traction by delivering enhanced security, cost-efficiency or convenience. Should these competitors offer a superior service, brand loyalty may be secondary to customer preference for an improved experience, potentially prompting a shift in market dynamics.

Regulatory Landscape

Visa and Mastercard's duopoly in the industry and high margins, unsurprisingly attracts regulatory attention. In Europe, the UK, and Australia, regulatory bodies have imposed caps on merchant interchange fees, yet these measures have not significantly impacted their revenue. In the US, where nearly half of Visa's revenue is generated, the proposed Credit Card Competition Act of 2022 aims to mandate banks to offer alternatives to Visa and Mastercard for transaction processing, potentially affecting popular rewards programs. After initially failing, the bill was reintroduced in June 2023, raising uncertainty about its future. Furthermore, Visa's attempted acquisition of Plaid in 2020 was blocked, indicating potential challenges for acquiring companies that could strengthen its position. These regulatory dynamics continue to shape Visa's strategic landscape.

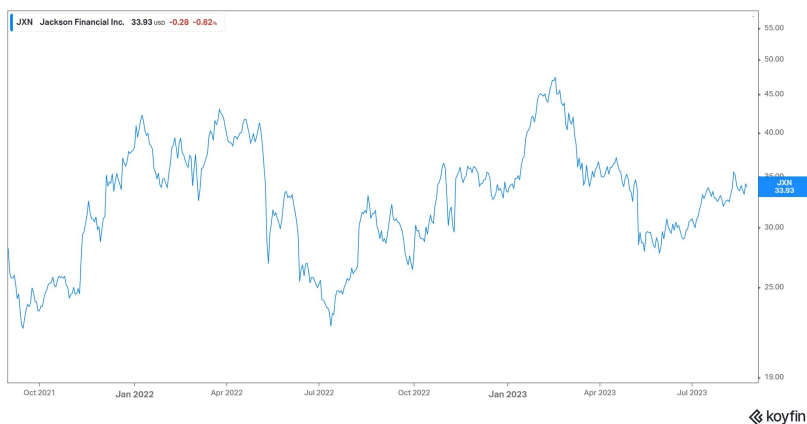
Competition from Disruptive Payment Systems

Global payment systems are experiencing disruption from various alternatives, spanning diverse categories such as Fintech platforms (PayPal), Buy Now Pay Later platforms (Affirm), Mobile payment apps (Apple Pay) and Blockchain-based payments protocols. Among these, digital wallets and mobile apps have gained the most traction. To date, the most successful competitors have been digital wallets and mobile apps. However, while these apps can operate without a network like Visa, most users link their wallets to a credit card to fund it. Moreover, central banks are exploring digital currencies, potentially challenging traditional payment networks in the long term. This landscape signifies the evolving nature of payment systems worldwide.



NYSE:JXN

Jackson Financial Inc (JXN) primarily provides a suite of annuities to retail investors in the United States. The company operates through three segments: Retail Annuities, Institutional Products, and Closed Life and Annuity Blocks. The Retail Annuities segment offers various retirement income and savings products. The Institutional



Products segment provides traditional guaranteed investment contracts. The Closed Life and Annuity Blocks segment offers various protection products, such as life insurance products, as well as various pay-out annuities. The company also offers investment management services. It sells its products through a distribution network encompassing many parties such as independent broker-dealers, banks, insurance agents etc. JXN was incorporated in 2006 and is headquartered in Lansing, Michigan.

Company Outlook

Encouraging Macro Trends

JXN is set to benefit from the current high interest rates, which allow it to increase its returns on investment while maintaining the cost of capital raised. Demographic trends are also providing a tailwind, as the company generates most of its operating revenue from the retail annuity segment, which targets US retirees.

According to the US Census Bureau, in 2020, there were 56 million Americans aged 65+, representing 17% of the nation's population. By 2030, this population group is expected to expand by 17 million people to encapsulate 21% of the population. Despite the short-term impacts of COVID-19, technological advances in healthcare will help increase life expectancy. Accordingly, those nearing retirement should be financially prepared for a retirement period which will last longer than in previous generations. This trend will boost demand for the company's core products.

Demographic trends have provided a significant tailwind for companies in the annuity and life insurance industries. Total industry revenue increased from \$776.7 billion in 2009 to \$945.7 billion in 2021, according to Statista. According to Market Research data, the annuity market will grow at a compound annual rate (CAGR) of 4.7% through 2026, driven largely by the aging of population.

Share Buyback Programme

In 2021, JXN management announced a share buyback scheme worth \$300 million, but have since expanded the programme twice by a total of \$750 million. JXN are currently reducing the number of shares in free float by more than 18%, sending positive signals to investors that internal management believed the company is currently undervalued, a sentiment shared by MorningStar's quantitative analysis, stating that JXN is currently trading at a 39% undervaluation from its Fair Value.



Dividend Stock

JXN currently pays a quarterly dividend of \$0.62 per share, boasting a dividend yield of 8.4%, offering investors downside protection in the event of market correction. It is probable that JXN will continue to distribute net income to shareholders as, at the end of 2022, JXN paid out a total of \$186 million to shareholders, corresponding to 3.6% of the firm's operating cash flow. This payout ratio implies a significant margin of safety and allows the company to multiply the dividend payments.

Stock Valuation

JXN has no direct competitors for a comparable valuation. The following table of comparable peer companies includes insurers with the most comparable nature of operations and internal risks, namely Corebridge Financial, Equitable Holdings, Globe Life, Primerica, Reinsurance Group of America and Voya Financial.

Company	Ticker	FWD (TTM)	FWD P/E	P/B	ROE (%)
Jackson Financial	JXN	1.9	2.04	0.3	22.69
Corebridge Financial	CRBG	2.55	4.42	0.95	27.86
Equitable Holdings	EQH	5.45	4.95	4.16	31.5
Globe Life	GL	11.71	10.14	2.62	13.52
Primerica	PRI	14.35	12.07	3.5	19.82
Reinsurance Group of America	RGA	7.51	8.22	1.25	8.07
Voya Financial	VOYA	9.35	8.81	1.72	9.63

Despite a relatively high return on equity, Jackson is trading at a significant discount to book value and is also cheaper than peers on major multiples: P/E: 1.90x, FWD P/E: 2.04x, P/B: 0.30x.

Risks

JXN's financials performance is closely tied to market dynamics. Should bearish sentiment come to fruition, JXN's financials may come under pressure. As the company earns on a spread, it is forced to balance between the cost of capital raised and the return of financial markets. To do this, Jackson actively uses financial derivatives. Derivatives are high-risk instruments because they provide built-in financial leverage. If the company's management makes mistakes in investment, it could pose a risk to the firm's financial stability.

Thesis Conclusion

Thesis: Buy

Given the opportunities presented from their macro environment, namely the ideal customer demographic and current high interest rates, JXN is not short of drivers to raise its future stock value. Furthermore, the promising indicators of large buyback programmes, matched with large dividends as downward protection and incredible valuable, are attractive as the SMF portfolio navigates the credit cycle. Finally, I believe this stock would be a lucrative asset to the portfolio due to its under-valuation when compared to its peers.



Inflationary pressures

NBFIs will be affected by interest rate increases in several ways. Many NBFIs are naturally well hedged against interest rate risk. For instance, insurers and defined benefit pension schemes employ strategies to align the movement of their investments (assets) with their commitments to future pay-outs (liabilities) to policyholders and pension recipients. Such approaches curtail their exposure to fluctuations in interest rates.

However, certain categories of institutions, such as, hedge funds and investment funds can have significant, complex exposures to interest rate risk. While the risks from higher interest rates are borne ultimately by their end investors, the response of these funds to losses induced by elevated interest rates could potentially amplify market movement. Hedge funds, often characterised by substantial leverage, may resort to deleveraging behaviours that involve selling assets, frequently as their prices decline, which can magnify market shifts in stressed conditions.

Furthermore, an increase in interest rates changes the attractiveness of certain investment strategies, potentially prompting investor withdrawals from funds or the reconfiguration of portfolios. For example, the recent continued outflows from open-ended property funds have been partly driven by higher rates. If redemptions take place rapidly, this might create liquidity pressures in certain markets. Rapid redemptions from funds operating in illiquid markets can lead to losses for asset holders. Consequently, these losses could induce further deleveraging among asset holders and generate sharp surges in liquidity demand. It might also lead funds to prioritise the sale of their most liquid assets first, potentially diminishing portfolio liquidity.

NBFIs with high leverage, less liquidity and weak risk management are particularly vulnerable to stress from higher rates. Entities that have adopted leverage-intensive investment strategies, along with those that heavily invested in less liquid assets during a period of abundant and inexpensive funding, will face difficulties generating returns amid higher rates. As such, these factors warrant careful consideration when selecting profitable stocks for investment.

Tightening Financial Conditions

A widespread economic slowdown coupled with tightening financial conditions has the potential to elevate credit risk. This is particularly relevant for investment funds exposed to low-rated bonds and loans, financial vehicle corporations engaged in securitisation and financial corporations engaged in lending. Materialisation of credit risk can precipitate losses, which, in the context of investment funds, may translate into substantial outflows and liquidity strains. The impact of heightened credit risk is notably pronounced within the commercial real estate (CRE) sector. Investors operating with leverage could find themselves compelled to offload CRE assets, intensifying downward pressure on prices and exposing unmitigated risks associated with a liquidity mismatch in real estate investment funds. Companies with a lower credit risk will be better equipped to face the challenges of a slowing economy.



High Inflation

As previously mentioned, high inflation brings many challenges for the insurance market. These challenges are discussed in greater detail in page 10 of this report.

Market Liquidity

Market liquidity risk could put further pressure on NBFIs engaged in liquidity transformation, as several indicators pointed to the deterioration of liquidity conditions in EU bond markets in 2022. Alongside cyclical liquidity risk, challenges persisted due to structural changes in liquidity provision and demand. The development of the investment fund industry in recent years has heightened the likelihood of substantial liquidity demands resulting from investor outflows during stress periods.

Increased cyclical liquidity risk could amplify shocks. Several indicators pointed to a deterioration of liquidity conditions in EU sovereign and corporate bond markets in 2022, as the provision of liquidity was reduced amid high volatility and further expected monetary tightening. Given uncertainty around changes in monetary policy, concerns about market liquidity remain, including potential collateral scarcity. Lower liquidity and market volatility can be mutually reinforcing and put further pressure on NBFIs performing liquidity transformation.

Similarly, the sharp decline in crypto-asset valuation was amplified by a broad-based decline in collateral values, triggering the unwinding of leveraged positions. Structural developments that might negatively affect liquidity provision, especially in times of stress, are related to the rise of electronic trading and the movement of banks away from a dealer-based model to a broker-based model.



Cybersecurity

Due to its heavy reliance on cutting-edge technology and the processing of sensitive financial data, fintech remains a prime target for cyberattacks. Privacy risks and the ever-expanding landscape of cyber challenges can lead to substantial economic losses and reputational harm, placing strains on the day-to-day operations of fintech entities and jeopardising the assets of both companies and their leadership. As the risk landscape for fintech companies continues to evolve, those that fail to adapt may encounter impediments to their business models.

While technology holds the potential to mitigate the frequency of certain risks, it can also exacerbate the severity of others. As FinTechs increasingly depend on technology and data to offer products and services previously provided by traditional financial firms, their reliance on interconnected systems introduces additional vulnerabilities for potential cyber exploitation. The greater the number of connected systems, the more avenues a cybercriminal has for launching attacks.

Diverging significantly within various subsectors, individual FinTechs require tailored risk management strategies to address their distinctive risk profiles. Leveraging the expertise of an experienced risk advisor can prove beneficial for building a sustainable risk management program encompassing risk mitigation and management measures, supplemented by risk transfer solutions. This approach ensures a comprehensive, long-term strategy that aligns with the unique risk challenges faced by each FinTech entity.

Supply Chain issues

(NBFIs) presently operate under less scrutiny and regulation than traditional banks. However, this scenario may transform as the Financial Stability Board (FSB) embarks on closer regulation of the sector. Consequently, the areas within the sector that currently experience fewer regulations are anticipated to encounter the most significant impact of these proposed changes, potentially facing fines and profit reductions.

For instance, the Fintech industry, due to its rapid emergence, largely operates without comprehensive regulation. Swift technological advancements and innovation have outpaced existing banking regulations, prompting the need for regulatory frameworks to catch up. This creates an uncertain landscape for Fintech companies as they await the extent of forthcoming regulations. Existing rules like the General Data Protection Regulation (GDPR) and Payment Services Directive Two (PSD2) establish data protection and infrastructure security requirements. Failure to adhere to these regulations not only exposes vulnerabilities to cyber-attacks but also carries financial and reputational penalties. Yet, one favourable aspect of regulation is that it compels FinTechs to uphold higher standards, nurturing industry growth and resilience.

While uncertainties linger, companies embracing new regulations are poised for success. This may entail challenging adjustments and investments in implementing new rules, including potential shifts in management. However, proactive endeavours promise future rewards, bolstering security and



consequently, enhancing profitability. Though stricter NBFIs regulation might constrain operational flexibility initially, it holds the potential to reduce the overall systemic risk associated with investing in the sector.

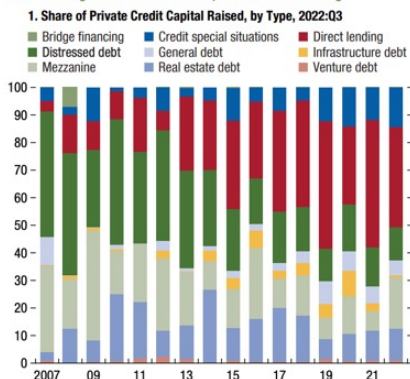
Private Credit Vulnerabilities

Private credit pertains to the provision of credit by NBFIs to borrowers through direct lending and alternative structures. In recent years, we have seen the private credit market transform from high levels of distressed debt to high levels of direct lending, depicting an increase in credit quality, as shown in the graph below. In terms of scale, the private credit market is comparable to the institutional leveraged loan market, which revolves around large bank syndications. Both markets held approximately \$1.4 trillion outstanding in 2022. However, interconnectedness is a key channel of risk, given that most private credit investors are usually institutional investors in the NBFIs ecosystem, susceptible to capital calls in times of broader market strain or potential losses on investments.

The rapid expansion of private credit markets may have heightened vulnerabilities within the financial system, carrying potential systemic repercussions. Privately financed leveraged buyout transactions featuring high debt multiples can exhibit heightened susceptibility to economic slowdowns. Intense competition in private credit has led to a deterioration in the quality of covenants, and private credit deal managers frequently finance deals managed by others, leading to risk concentration. Lending within this domain is largely opaque, resulting in an accumulation of risks related to asset quality performance. These risks might remain elusive to market participants and regulators until it's too late to counteract.

Private credit constitutes a relatively new asset class, with its performance untested during prolonged economic downturns. If private credit were abruptly constrained during a market stress event, smaller borrowers could face rollover risks if existing bank financing is insufficient to accommodate new credit demands under current regulations. The inherent opacity and limited liquidity of private credit markets could potentially lead to spill-over effects into other markets during stress episodes. This could arise as investors are compelled to liquidate other assets possessing more timely mark-to-market pricing and more liquid secondary markets to access cash.

Direct lending is the main source of private credit financing.



Pension funds are the largest investors in private credit vehicles.

