Betting on the Future of Wealth Management

After the financial crisis, this firm undertook a massive restructuring program. Led by a new CEO, the financial giant sought to cut back its investment banking activity, strengthen its capital position, and focus on the wealth management business.

Today, we can say that restructuring has been an unqualified success. The wealth management business delivers consistent profitability and has invested in technology to fuel significant growth. In addition, the bank is well capitalized and has done a good job at controlling costs.

In our recent article, "Big Banks Will Win the Fintech Revolution," we named this firm as our top pick in the wealth management space. This article gives more insight as to why investors that want to benefit from new technologies in finance should choose this week's Long Idea, UBS (UBS: $17/share).

Wealth Management Looks Strong

Since 2011, UBS has focused on building up the wealth management divisions as its core asset. It engages in investment banking activities primarily as a subsidiary to its wealth management business. The investment bank can provide specialized products for UBS' ultra-high net worth clients while taking on relatively little risk.

As a result, UBS now counts nearly half of the world's billionaires as clients. The firm is a leader in wealth management all around the world. As Figure 1 shows, UBS' strategy has helped it earn a return on invested capital (ROIC) at the top of its peer group.[1]

Figure 1: Leading Profitability Among Peers

Ticker	Company Name	Return on Invested Capital (ROIC)
UBS	UBS	11.1%
GS	Goldman Sachs	9.5%
JPM	JPMorgan	9.2%
BLK	BlackRock	9.1%
MS	Morgan Stanley	8.6%
BAC	Bank of America	6.3%
HSBC	HSBC	4.3%
C	Citigroup	4.2%
BCS	Barclays	2.3%
DB	Deutsche Bank	2.3%
CS	Credit Suisse	2.1%

Sources: New Constructs, LLC and company filings.

CEO Sergio Ermotti reportedly faced a great deal of opposition to his restructuring plan at first. The numbers today show he chose the right course.

Building for the Future of Wealth Management

If anything, UBS' 11% ROIC for 2016 understates its long-term profitability. A decrease in client activity led to lower fee and commission income last year, but the wealth management business continued to add new money. Growth was especially strong in UBS' Wealth Management Americas division, which saw a 9% increase in invested assets.

[1] We do not have data for peer group members BNP Paribas, Julius Baer, and Standard Chartered.

In addition, ROIC was pulled down by significant investment in technology. UBS committed last year to spending $1 billion to unify the IT platform for its wealth management business. In the long run, this investment should help UBS fulfill the dual mandate of lowering costs and delivering a higher level of service to clients.

Wealth managers that can fulfill this dual mandate will be poised to reap significant gains in the near future. Wealth management remains a highly fragmented industry, and 4 out of 10 clients say they're open to changing wealth managers under the right circumstances.

The potential market share gains are too big an opportunity to ignore, and we're already seeing more intense competition in this space. Most recently, Morgan Stanley (MS) pulled out of the protocol for broker recruitment in an effort to make it more difficult for advisors to leave and take clients with them.

UBS' IT investment is a part of the same trend. A superior IT platform can help firms retain advisors and add new clients. The company has made a conscious decision to focus on technological capabilities as its competitive advantage. From CEO Ermotti in a recent interview with Bloomberg:

> "I'm totally convinced that the battleground of banking is not the front office. The battleground is the back end. There's no understandable reason why the financial-services industry has not developed a more comprehensive sharing of the value chain."

In addition to investing heavily on its own back-end infrastructure, UBS has partnered with several FinTech startups to improve its service. In just the past couple years, UBS has:

- Developed a machine learning investment strategy with New York-based Tradelegs.
- Partnered with robo-advisor SigFig.
- Built a stable of startup partners through its Future of Finance challenge.

These investments may take time to bear fruit, but they show that UBS understands the opportunity provided by new technologies in the wealth management industry.

Enhanced Stability in a Global Economy

In addition to its superior profitability, UBS stands out as one of the safest and best capitalized global banks. According to fixed income specialists Viola Risk Advisors, only Morgan Stanley comes close to matching UBS among the major banks in terms of profitability and capital position.

UBS' large capital buffer and relatively conservative investment banking activities make it much safer than the typical global systemically important bank (GSIB). If another financial crisis hits, UBS should fare better than most of its competitors.

Fee Headwinds Can be Managed

Like all wealth managers, UBS faces significant pressure on fees and commissions. As transparency around fees increases, clients are increasingly pushing fees lower. This represents a headwind for the profits of the entire industry.

On the other hand, fee transparency also represents an opportunity. Wealth managers that fail to adapt will either keep their fees too high or reduce their level of service and shed clients. Smart firms like UBS that have invested in the technology to improve their service while cutting costs will be able to pick up these new clients and gain market share without sacrificing profitability.

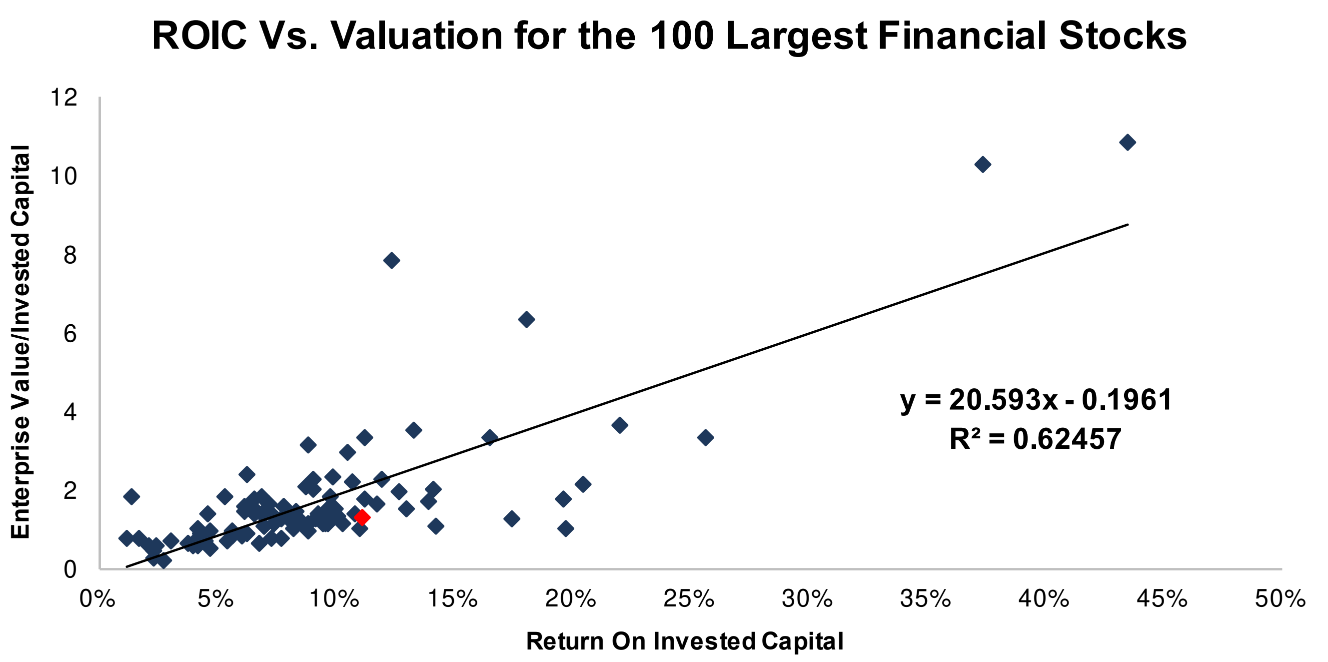
We believe the opportunity here outweighs the risks. Still, investors should be aware that falling fees could have a negative impact in the near-term on revenues and profits for the wealth management division.

"The World's Most Expensive Investment Bank and Its Cheapest Asset Manager"

That's what Ermotti called UBS in his Bloomberg interview in October. Many analysts and rating agencies still treat UBS as an investment bank even though over half the company's profits now come from wealth management.

This miscategorization helps explain why UBS remains undervalued. Analysts and investors overstate the risks of the investment bank and understate the opportunities for growth in wealth management. Figure 2 shows a regression analysis of ROIC[2] against enterprise value/invested capital (a cleaner version of price to book) for the 100 largest companies by market cap we cover in the financial sector.

Figure 2: Regression Analysis of the Financial Sector



Sources: New Constructs, LLC and company filings.

Figure 3 shows the actual value for the largest wealth managers compared to their implied value from the regression analysis in Figure 2.

Figure 3: UBS Is the Cheapest Wealth Manager

Company	Ticker	ROIC	Actual EV/IC	Implied EV/IC	Discount (Premium) to Implied Valuation
UBS	UBS	11.1%	1.32	2.09	58%
Morgan Stanley	MS	8.6%	1.15	1.57	37%
JP Morgan	JPM	9.2%	1.28	1.70	33%
Bank of America	BAC	6.3%	0.91	1.10	21%
Wells Fargo	WFC	8.1%	1.22	1.47	21%
Bank of New York	BK	7.4%	1.13	1.33	18%
Goldman Sachs	GS	9.5%	1.15	1.76	15%
Northern Trust	NTRS	7.8%	1.56	1.41	(10%)
Charles Schwab	SCHW	10.5%	2.93	1.97	(33%)

Sources: New Constructs, LLC and company filings.

ROIC explains 62% of the difference in valuations for large financial companies. With an ROIC of 11% and an EV/IC of 1.34, UBS trades at a 58% discount to its implied valuation based on the trend line in Figure 2, the biggest discount among the top wealth managers.

[2] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

Our DCF model tells a similar story. If UBS can grow NOPAT by just 4% compounded annually for the next decade, it has a fair value of $28/share today, a 65% upside to the current price.

Auditable Impact of Footnotes & Forensic Accounting Adjustments

Our Robo-Analyst technology enables us to perform forensic accounting with scale and provide the research needed to fulfill fiduciary duties. In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to UBS' 2016 20-F:

Income Statement: we made $3.2 billion of adjustments, with a net effect of removing $3 billion in non-operating expense (11% of revenue). The most notable adjustment was the removal of $750 million in restructuring expenses. We removed $85 million in non-operating income and $3.1 billion in non-operating expenses. You can see all the adjustments made to UBS' income statement here.

Balance Sheet: we made $29.6 billion of adjustments to calculate invested capital with a net decrease of $7.6 billion. The most notable adjustment off-balance sheet adjustment was $5.2 billion in discontinued operations. This adjustment represented 8% of reported net assets. You can see all the adjustments made to UBS' balance sheet here.

Valuation: we made $7.2 billion of adjustments with a net effect of decreasing shareholder value by $6.1 billion. The most notable adjustment was $3.8 billion in off-balance sheet operating leases. This adjustment represents 6% of market cap. Despite the net decrease in shareholder value, UBS remains undervalued.

Executive Compensation Could be Better

UBS links a significant portion of long-term executive compensation to adjusted return on tangible equity, which is a pretty common metric used by big banks. We've written before why return on equity is a flawed metric and should not be given the prominence it has in the investing community.

UBS' compensation plan addresses some of these concerns. They do make some adjustments for accounting distortions, and executive bonuses are also tied to equity ratios, which discourages excessive leverage. Most importantly, UBS executives have not been paid handsomely while destroying shareholder value. Since 2014, UBS' economic earnings have improved from $1.1 billion to $2.4 billion.

Regardless, the company would be better off using ROIC, which is more easily comparable to peers, less subject to accounting distortions or manipulations, and highly correlated with increasing shareholder value.

Insider Trading and Short Interest Trends

There is almost no short interest in UBS. There are currently 4.9 million shares sold short, or ~0.1% of the float. We do not have access to data on insider trading trends for UBS.

UBS Provides Potential for Additional Capital Return

UBS currently offers a 3.5% dividend yield. While the bank has not bought back shares in recent years, that could be about to change. With the bank's profitability and capital buffers improving, Ermotti has signaled that a buyback could be in the bank's future.

With shares undervalued and the company already investing in growth opportunities, a buyback could generate significant value for investors.

Attractive Funds That Hold UBS

Since UBS is a Swiss company, and we primarily cover domestic funds, there are no funds under coverage that allocate significantly to UBS.

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Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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