Annual Investment Outlook

IIAC 2016 Survey of Canada's Investment Dealer CEOs

Interpretation of the Executive Outlook for Capital Markets and the Investment Industry

Presented to

The Empire Club of Canada

By

Ian Russell

President and CEO, The Investment Industry Association of Canada

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Good afternoon, everyone. I am delighted to join you once again for the Empire Club's Annual Investment Outlook luncheon.

For the past five years, the IIAC has polled the CEOs of our 132 investment dealer member firms. Our aim was to obtain an up-to-date snapshot of executive thinking on economic and financial market trends.

These trends have provided insights on the outlook for advice, for securities trading, and for investment banking.

We asked executives to identify the business challenges and opportunities they foresee in the year ahead.

The real questions on everyone's mind are, "Will we simply see just another year of mediocre industry performance?" and "Will improving business conditions enable the industry and its member firms to break out of the doldrums and move to new highs?"

The 2016 survey was conducted last year from November 3 to November 25. The survey coincided with the outcome of the U.S. election, and, as a result, responses to the survey questions were influenced by the positive market tone that emanated from the election outcome. For example, by early December, U.S. stock market indices had moved to record levels and the TSX was approaching an all-time high.

Stock market performance, of course, is no guarantee of reality. However, there is reasonable expectation that economic momentum will strengthen if Congress pushes through some of the proposals of President-elect Trump, notably cuts to personal, corporate and investment taxes, as well as increases in infrastructure spending, and deregulation.

This general optimism post-US election may explain why the majority of CEOs in our survey felt less vulnerable to a major external shock that could affect financial markets.

Of the survey respondents that did feel vulnerable to an economic shock, 44 per cent, or nearly half, pointed to a domestic concern – a housing market correction; 33 per cent highlighted a geopolitical uncertainty; and only 22 per cent pointed to a sovereign debt crisis as the most likely shock.

Recent economic and political events in Europe certainly suggest a more cautious optimism is warranted with the possibility of an external shock. The resignation of Italian Prime Minister Renzi, following the Italian constitutional referendum, could open the door for more anti-EU parties to form the next Italian government. This, along with the Brexit negotiations and impending elections in France and Germany, could lead to more volatile and unsettled global markets. Indeed, another financial crisis could be lurking around the corner.

While executives are less concerned about the impact of a major shock to the market, they still nonetheless recognize the industry will continue to undergo massive structural change from the demographic, competitive, regulatory and technological trends sweeping the industry.

We asked Canadian CEOs, "What are the major trends transforming the investment industry?" They answered as we expected – regulatory changes, intense business competition, weakness in commodities markets, demographics, and technology. Even though these trends are considered significant and may have negative consequences from needed investment and changes to business models, especially in the short-run, many CEOs have taken a positive view on the revenue outlook for this year.

The majority of CEOs surveyed expect their operating revenue to increase at a faster rate than in 2016. Thirty-five percent project operating revenue to grow in line with 2016.

Just five percent of CEOs expect their operating revenue to increase at a slower rate.

The survey went on to provide greater detail on the outlook for revenue components.

The results indicated that CEOs expect the retail business will remain the largest contributor to industry revenue this year.

The large integrated firms, in particular, have invested heavily in their wealth management businesses, providing a wide array of financial products and services to improve earnings and return on equity.

The retail business benefits from an aging population. Demands for services such as financial and estate planning will escalate.

Over the next decade, we will see the largest intergenerational wealth transfer in Canadian history. And the amount will grow even larger in subsequent decades.

The investor profile is rapidly changing. The industry will have to adapt to a new generation of investors – the millennials – with their ever-increasing decision-making power and earnings capacity. These investors are different from the baby-boomer investor, in terms of trust in the system, weight given to loyalty, and independence.

Online investing has come to the fore in wealth management, reflecting technology advances and its appeal to millennial investors.

Industry executives were split on the value of online investing to their clients.

Nearly half the survey respondents felt online advice was more helpful to smaller clients with limited resources. These clients deal mostly with the larger financial institutions and not the investment dealers.

The next question we posed was “Which of the following best describes your attitude to robo-advisors or online advice?”

Approximately two-thirds of CEOs surveyed felt robo-advisors are likely to take away some business from full-service advisors – more complimentary to the advisory business than substitutional. Forty per cent felt robo-advisors were important to build relationships with younger clients (i.e. Millennials); and another 40 per cent felt robo-advisors were helpful to service smaller clients.

There will be greater customization of business models that cater to different segments of clientele, offering different mixes of products and services; and different types of online advice models. All delivered through advanced mobile client-advisor interface and use of social media. The goal is designed to retain existing, more sophisticated clients as their needs change, meet the unprecedented demands of millennial investors and improve the cost-effective delivery of advice to smaller investors.

Now that we have dealt with the questions related to the wealth management business, our largest business component, the survey turned to the weakest revenue contributor.

We asked CEOs, “What will be the weakest revenue contributor for your firm in 2017?”

The vast majority said underwriting in debt securities. This response indicates a sea-change in bond market sentiment.

Our next question was “Do you anticipate investment banking activity in 2017 to eclipse 2016 levels, remain near 2016 levels or fall below 2016 levels?”

The majority answered in the positive saying it would exceed last year’s level.

This positive view mainly reflects increased equity issuance from growing optimism for a better economy, more buoyant stock markets, a lower cost of equity capital and higher energy prices. Mergers and acquisitions could also pick up with an improving outlook, particularly in the energy sector. As well, cross-border acquisitions could improve given prospects of a weaker Canadian dollar and an improved corporate tax climate in the U.S.

We also asked CEOs what they thought about equity financing prospects in small cap private and public markets. We asked, “Do you think 2017 will be a strong year in the Canadian private equity market?”. As you see, the survey results were evenly split, with 47 per cent saying “yes”; and 53 per cent saying “no”.

This is a surprising outcome in view of the growing importance and sophistication of Canadian private equity markets in recent years.

Over the last several years, the performance of the public venture markets has been dismal. CEOs confirmed in our survey that these weak conditions are unlikely to change this year. Not a good sign for mid-sized companies needing capital to expand their business.

Let's move on to operating costs.

A big factor weighing down dealer performance in recent years has been the relentless rise in operating costs. As you see on the chart, the majority of CEOs reported that their operating costs have increased significantly in the past four years.

Nearly half the CEOs surveyed anticipate their operating costs will increase at a faster rate in 2017 and another 40 per cent expect operating costs to increase at least at the same rate as last year. Only 15 per cent see costs rising at a lower rate.

The next question was "What was the top cost pressure facing their business?" The answer is not surprising. Seventy per cent said it was compliance costs. The explanation can be traced to the significant ramping up in compliance requirements to meet an expanding rulebook.

Now on to technology. New technology applications have been introduced in the last few years to strengthen the client-firm interface, improve account record-keeping, facilitate trade execution and securities clearing and settlement, and meet compliance requirements. These services are delivered through in-house systems, third-party service providers and the carrying brokers.

Sixty-five per cent of firms expect to spend more on technology in 2017 than in 2016. Thirty-five per cent expect to spend about the same.

We asked: "What is the main driver of the technology spend?" We were expecting firms to point to compliance requirements. What was most surprising is that 60 per cent of firms surveyed identified other factors.

The majority of CEOs in fact indicated the technology spend was devoted to improvements in firm operating efficiency and the defenses against cyber threats.

Indeed, 60 per cent of firms said they expect the technology spend in cybersecurity in the next two years to exceed the previous two years.

The financial industry is heavily targeted – facing 300 per cent more cyber attacks than other sectors. Our member firms have become increasingly aware of the scope and sophistication of cyber attacks and the large reputational risks at play.

Thirty per cent of the firms indicated that the technology spend was mainly related to streamlining processes in the front and back offices of firms. Smaller firms have focused on these technology applications to reduce costs and compensate for lack of scale.

Even with greater optimism about the coming years' prospects, we remain concerned that many small firms will not benefit much from the improving outlook.

As you know, the industry has lost over 60 boutique firms since 2012, and another 50 firms are losing money – most on a consistent basis.

Roughly one-quarter of the small firms in the investment industry will continue to struggle from difficult competitive pressures and the steady escalation in fixed costs from technology and regulatory change. Many of these firms are likely to eventually merge with competing firms or simply close their doors.

Our survey confirmed this conclusion. Fifty-five per cent of CEOs surveyed expect the number of firms exiting the industry in the next two years to be higher than in the previous two years.

In closing, the IIAC CEO survey struck an optimistic chord this year, as executives anticipate a year of stronger economic growth and improving equity market conditions. The optimism partly stems from an expected economic lift from impending "supply-side" policy changes, including lower taxes, and deregulation from the new U.S. Administration.

The wealth management business, the most steadily successful business line in the industry, is expected to benefit most from a stronger economic and financial outlook.

However, institutionally focused firms will also benefit in the coming years from better conditions in equity markets for new offerings, especially large and mid-sized companies, and stepped up mergers and acquisitions activity.

We also observe that a core group of smaller firms, a critical mass of some 70-80 firms, have built strategic niche businesses, cut operating costs to the bone, and adapted technology to compete effectively and compensate for lack of scale. These firms have met the competitive and cost challenges in today's markets.

The optimistic outlook for business conditions this year from the survey results will enable these smaller firms to go beyond surviving a tough market, to improve earnings and returns, expand operations and contribute to more competitive and diversified capital markets in Canada.

Thank you.