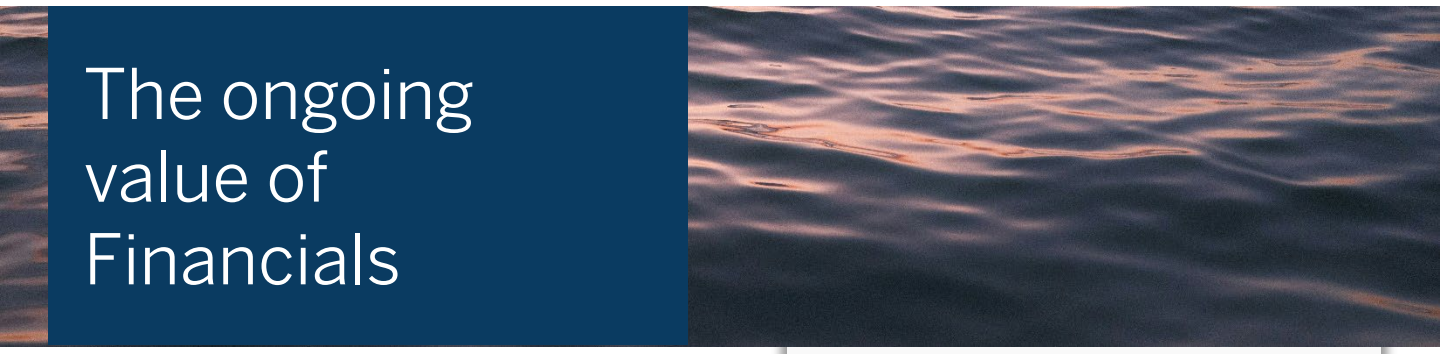
Brown ADVISORY Thoughtful Investing.

The ongoing value of Financials



The Financial Services industry may have been out of the market spotlight in recent years, but it has continued to quietly offer compelling returns. The sector outperformed the S&P 500® Index over 1, 3 and 5 years (Chart 1), underlining its status as a core long-term portfolio allocation.

Key to the industry's success is that financial companies are central to the workings of the wider economy. Extending far beyond traditional banks, the sector includes stock exchanges, insurance companies, alternative asset managers and payment providers. And as the providers of integral services, these businesses have become important bellwethers for measuring the health of consumer sentiment and the strength of the wider global economy.

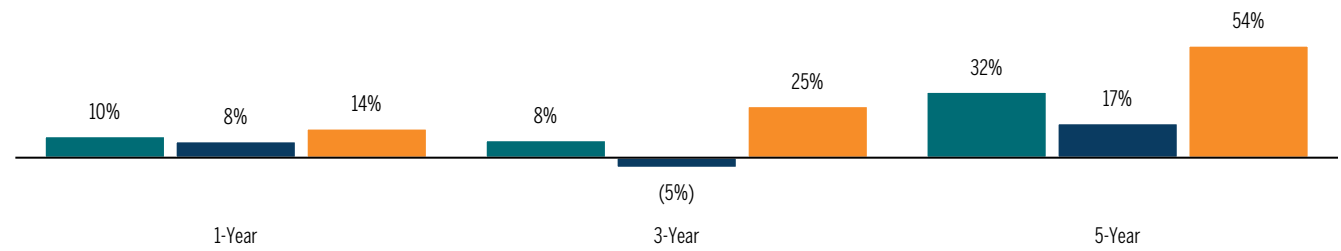
Macroeconomic tailwinds have helped drive performance. 2024's much-forecasted recession failed to materialize, while moderating inflation enabled the Federal Reserve (Fed) to start its rate-cutting cycle, both of which boosted consumer net worth and capital market activity. However, in 2025, many of these economic tailwinds have become headwinds, reflecting uncertainty around the Trump administration's tariff-focused economic agenda. Financials have so far continued to outperform the wider market, albeit with different drivers, but what does the future hold for the different sub-sectors?

Fast Reading

- The Financial Services industry has consistently outperformed the broader market, defined here as the S&P 500® Index over 1, 3, and 5 years, highlighting its importance as a core long-term portfolio allocation.
- The sector has benefited from favorable macroeconomic conditions, such as moderating inflation and the Federal Reserve's rate-cutting cycle, although recent uncertainties around economic policies have shifted the drivers of performance.
- Key growth areas in the sector include the expanding runway for the payments industry, broadening growth opportunities for alternative asset managers, and the counter-cyclical nature of Financial Market Infrastructure, which can benefit from market volatility.

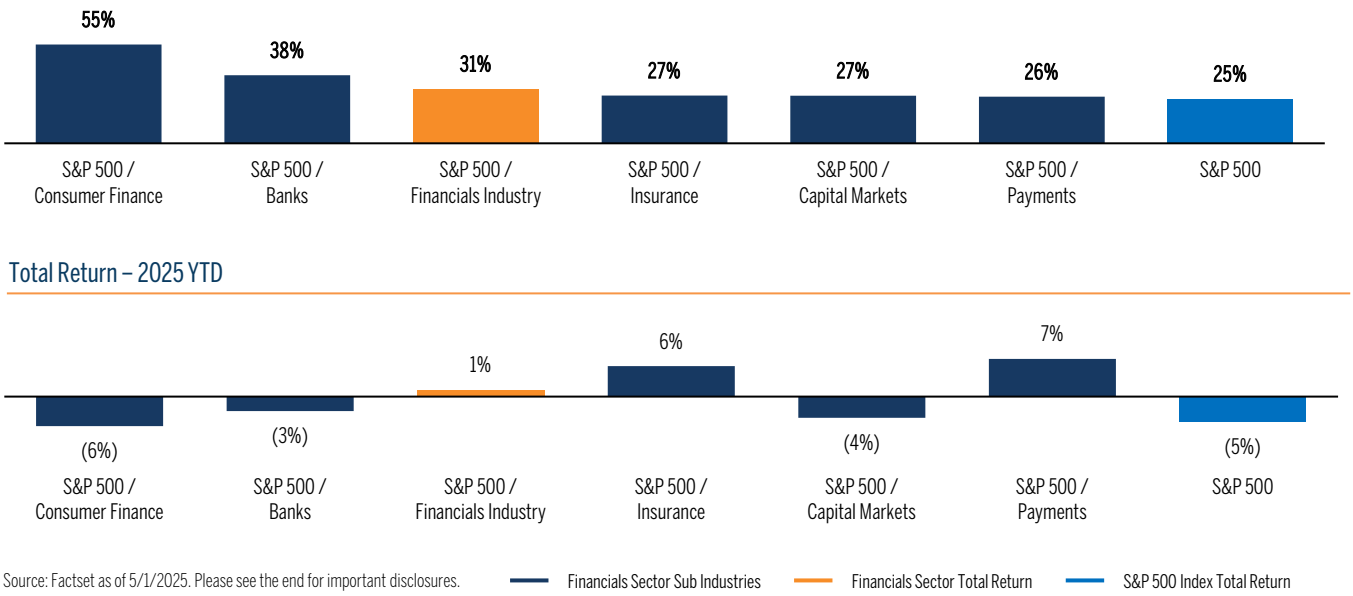
Chart 1: The Financial Services industry has generated strong returns over time

Relative Total Return of the S&P 500® Financials



Source: Factset as of 5/1/2025. Please see the end for important disclosures.

Chart 2: Financials are still outperforming but the drivers have shifted



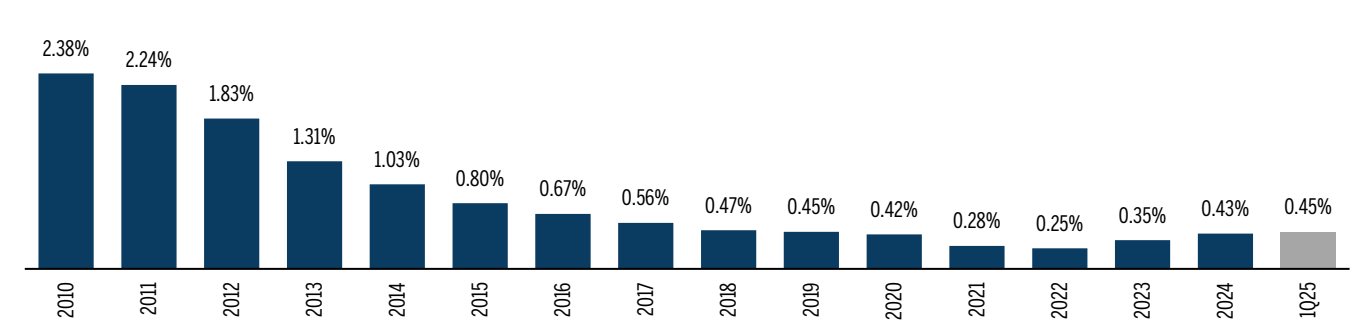
Source: Factset as of 5/1/2025. Please see the end for important disclosures. Financials Sector Sub Industries — Financials Sector Total Return — S&P 500 Index Total Return

Banks signal stable, but cautious, financial health among corporates and consumers

Banks have understandably been caught in the crosshairs of this year's volatile markets, but fundamentals remain attractive. Despite US economic growth shrinking in the first quarter of 2025, the ratio of non-performing assets across the banking industry is just 45 basis points (bp), suggesting credit levels remain strong. In fact, banks' latest earnings updates almost uniformly signaled that corporates and consumers remain in good financial health, although both are becoming more cautious while they wait to see how the economic scenario progresses. This sense of caution is leading to less spending and less demand for borrowing, both of which translate to muted loan growth prospects for banks.

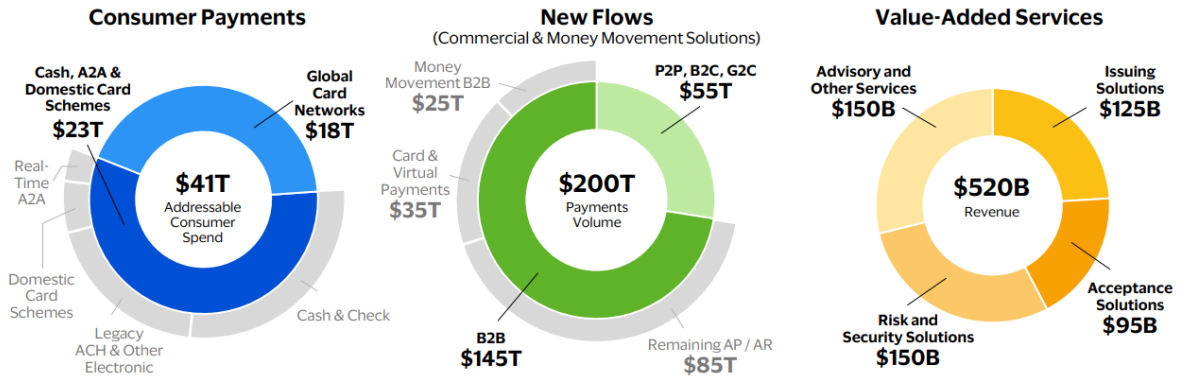
However, for investors factoring a recession into their scenario analysis and fearing parallels with 2008, the outlook is promising. The overall operating status of banks is far more secure than it was going into the Great Financial Crisis. Legislation, such as the Dodd-Frank Act, has required banks to hold far more capital and maintain higher levels of liquidity, and it has led to a significant de-risking of balance sheets, with fewer levered loans or exposure to sub-prime mortgage-backed securities. The improved capitalization of banks is exemplified by many of them conducting share buyback programs, which are both impactful and attractive for shareholders.

Chart 3: Loans are being paid back



Source: S&P Global. Represents average of U.S. publicly-traded banks. Data as of 3/31/2025. Please see the end for important disclosures.

Chart 4: Broadening of opportunities for payments industry



Source: Visa Investor Day February 20, 2025. Please see the end for important disclosures.

Expanding runway for payments industry

Payments networks have been the beneficiaries of the long-term transition to a more cashless society. As penetration rates rise, will the growth of these networks remain sustainable? Despite the scale of the electronification of payments over the last few decades, we see further potential. While the perception is that developed markets are nearing full penetration, there is still a high level of cash and check transactions taking place. In addition, personal consumption is growing every year, suggesting payment networks are still expanding into this growing market. Payment companies are also reaping the rewards from the ongoing shift to e-commerce – which is entirely cashless. Finally, governments are supporting the drive to increase the penetration of electronic payments.

The opportunity set across developing markets is even greater. Alongside banks, networks are partnering with neobanks, fintechs and the providers of digital wallets to facilitate the use of card or digital transactions by the underbanked, and even the unbanked. Networks are also focusing on expanding the acceptance of non-cash payments by merchants, with QR codes and apps making it easier for merchants to accept such payments.

Beyond the core consumer payments business, we see two new levers for growth. The first is new money flows. For decades, networks have concentrated on digitizing transactions from consumer to business; now, they are looking to reverse this by enhancing the services available to businesses. This could entail insurers dispersing policy payouts directly, governments disbursing aid programs or paying benefits straight to recipients. From a business-to-business perspective, this could improve cross-border payments as well as enhance the efficiency of accounts payable. The scope of addressable opportunities in new money flows could become a significant growth engine for these businesses. Secondly, a greater number of value-added services are being adopted. These are often ancillary services, such as fraud prevention, tokenization, and advisory and consultancy services.

Despite years of growing penetration, we believe the addressable opportunity in the payments sector remains large and warrants being part of diversified portfolios.

Broadening distribution opportunities for alternatives

Alternative assets managers is a subsector of the capital market space which has seen huge growth in assets and revenue valuations over the medium term. However, these businesses have faced cyclical headwinds so far this year after expectations that benign capital markets would enable alternatives managers to return capital to clients, have been overturned by market volatility. Despite these near-term struggles, we remain excited by the growth opportunity for these businesses and find that recent drawdowns have resulted in valuations becoming more attractive. In particular, as the private equity industry matures, its accessibility to global investors has also broadened, especially in Asia. Lesser-known sub-asset classes are also gaining traction; private credit has benefited from a tightening in traditional lending channels, and more infrastructure projects are now being funded through private channels. The challenge to successfully investing in alternative assets managers lies in being able to ascertain the tangibility of their growth opportunities. At Brown Advisory, our due diligence process leverages the breadth of our platform. Our investigative team conducts in-depth fundamental research, while the interaction of our private client team with such businesses means they are better placed to gauge the strength of their distribution reach.

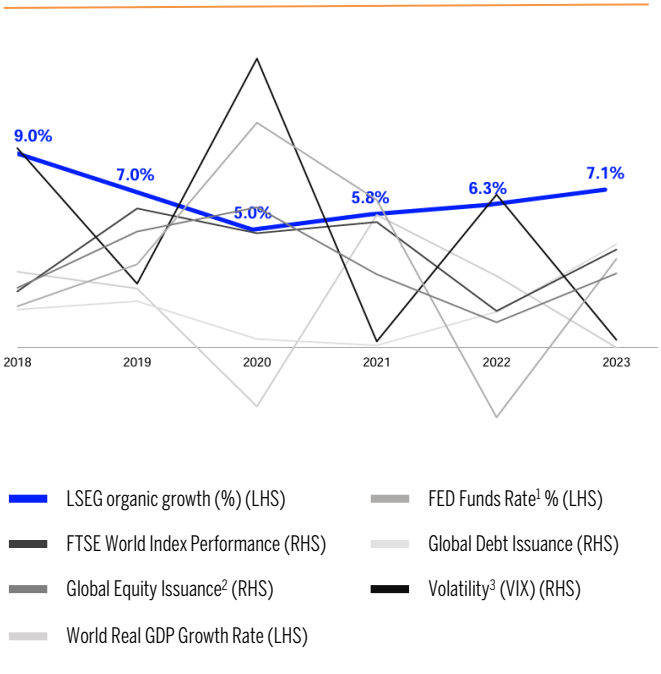
In addition, we have conducted our own market research to measure the appetite for alternative products in the retail market, and to better understand how private credit lending can benefit small to medium-sized businesses.

Financial Markets Infrastructure: Beneficiaries of volatility

Financial Markets Infrastructure is an often-overlooked part of the Financials space. These businesses provide the plumbing that enables Financial Markets to operate effectively, including stock exchanges and the providers of benchmarking or data. Services that are hard to substitute and can be mission critical. These high-quality and differentiated businesses boast strong network effects, have the advantage of scale and tend to be well-regarded by regulators due to the risk mitigation services they provide.

Importantly for the current times, such businesses tend to be counter-cyclical in nature and therefore provide a more defensive proposition during times of macro uncertainty. For example, in a bid to mitigate volatility, market participants are more likely to hedge risk, leading to a higher volume of transactions for core exchanges. In uncertain times, nervous investors seek greater reassurance from the surety of data and analytics. For these companies, volatility and market uncertainty are good for business and support pricing power. As well as cyclical drivers, this is a sub-sector where businesses have strong secular long-term growth, providing a useful all-weather aspect for portfolios.

Chart 5: London Stock Exchange Group has a track record of uncorrelated, all-weather growth



Source: London Stock Exchange Group investor presentation April 2024 representing the most recent data available. (1) Average monthly effective Fed rate. (2) Equity and debt issuance 2023 YTD vs 2022 YTD. (3) Volatility measured using average daily Volatility Index (VIX) for year. Please see the end for important disclosures.

Delivering best-in-class returns

At Brown Advisory, we recognize the value of the Financials sector, and our notable exposure to the sector ranges from 10% to 25% of holdings. We approach the sector from several different vantage points, dividing the industry into five primary subsectors: Banks (25%), Insurers (25%), Capital Markets (20%), Payments (20%) and Financial Infrastructure (10%), in the view that each of these subsectors represents a sizeable hunting ground for potential investments.

On top of that, we have identified three distinct company types within this universe. Secular growth companies are very long-term businesses with competitive tailwinds, such as payment providers like Visa and Mastercard. Cyclical, secular growth businesses are companies that still benefit from secular growth tailwinds, that also have cyclical aspects to their businesses – for example, alternative assets managers such as KKR or data providers like Moody's. Finally, cyclical businesses encompass many of the traditional Financial Services industries like banks and insurers, which are commonly associated with the sector as a whole.

We are philosophically fundamental, bottom-up investors and have a lot of confidence in our Financial Services holdings, but also apply a prudent approach to portfolio construction. Our strategy allocations to Financials follow a barbell principle, where core structural growth businesses are paired with cyclical structural growth businesses, meaning high beta and offensive exposures are neutralized with low beta and defensive holdings, thereby eliminating unwanted factors or risks, such as interest rate changes or shifting market asset values. The final piece of the puzzle is to complement this approach with the addition of truly unique businesses that are undiscovered and unappreciated by the market – a pursuit underscored by our commitment to rigorous research and investment. We feel this combination helps us to deliver best-in-class returns for our clients.

For more insights about our views on the Financials sector, please click here to watch the full webinar.

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Terms & Definitions

The **Total Return** of an equity security is the sum of the return from price movement and the return due to dividend payments or other sources of income. Standard benchmark-, sector-and portfolio-level returns are the sums of the weights of each security multiplied by its return, summed and calculated daily and summed over the period covered by the report or by an otherwise-noted period. **Volatility** is a statistical measure of the dispersion of returns for a given security or market index. It is often measured from either the standard deviation or variance between those returns. In most cases, the higher the volatility, the riskier the security.. Beta is a measure of portfolio volatility. It is equal to the ratio of a portfolio's volatility relative to its benchmark index's volatility over time. It is equal to the excess return of a portfolio over a risk-free investment, minus that portfolio's expected return given its volatility relative to its benchmark index.