SECTOR INSIGHTS
U.S. Financials Sector

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"Financials are the lifeblood of the economy." - Mark Dawson

The financial services sector is unique. Unlike other sectors, it is essentially the lifeblood of the economy. When it's healthy, it provides businesses and consumers with access to the credit, capital and investments that are vital to a healthy and growing U.S. economy. But when it's sick, as we saw during the financial crisis in 2008, it can weaken the whole system. Severely damaged in 2008, the U.S. financial system - in particular banks - have been healing. Now is a good time to seek out investment opportunities in financial stocks.

Interest Rates

After years of ultra-low interest rates, we believe the Federal Reserve is poised to raise short-term rates. Key issues are the timing of an increase as well as the pace and magnitude of subsequent increases once the first tightening is implemented.

What is the likely impact of rate increases on stocks? From 1999 into 2000, the Fed raised its discount rate from about 3.75% to about 6.5%. During that time, the S&P 500 rose by 50% from just under 1,000 to about 1,500. When the Fed raised rates 14 times from 2004 into 2006 – from 1% to 5.25% -- the S&P 500 rose nearly 30% from about 1170 to above 1500. If history is any guide, and if the Fed raises rates modestly over time in response to improving economic fundamentals, the equity markets are likely to rise, not fall, as the Fed raises rates.

Banks

Annual bank stress tests, implemented post the financial crisis in 2008, are one of the Federal Reserve's most important tools to gauge the resiliency of the financial sector and to help ensure that the largest firms have strong capital positions. The 31 banks tested this year represent more than 80% of assets held by domestic bank holding companies, or $14 trillion as of the fourth quarter of 2014.

The banks actually undergo two tests as part of the process. The first is the Dodd-Frank Act stress test (DFAST), which measures how banks hold up under hypothetical economic conditions.

DFAST tests whether banks have sufficient capital to absorb losses and support operations during adverse economic conditions, while using a standardized set of capital action assumptions. The assumptions keep each bank's current dividend and do not include share repurchase plans.

This year's scenario featured a deep recession with the unemployment rate peaking at 10%, a decline in home prices of 25%, a stock market drop of nearly 60% and a significant rise in market volatility.

The banks are then evaluated by the Federal Reserve with the arguably more important Comprehensive Capital Analysis and Review (CCAR). The CCAR tests banks under similar adverse economic scenarios, this time using the banks' own capital action plans. Under CCAR, a bank submits its proposed capital plan for the next four quarters (including any planned dividend hikes, share buybacks, etc.), and the Fed assesses whether that bank would be able to meet required capital ratios with the proposed plan under poor economic conditions.

The Fed may object to a capital plan based on quantitative or qualitative concerns, including a firm's projected capital and the strength of the firm's capital planning processes. If the Federal Reserve objects to a capital plan, the institution may not make any capital distributions unless approved by the Fed. This means the bank can't raise its dividend or buy back stock, which takes away key reasons to invest in bank stocks.

Fortunately, this year marked an important milestone for the industry, as it was the first time since the stress tests were started that all U.S. banks passed.

So what does this mean for the U.S. banking industry? It means U.S. banks have substantially increased their capital since the first round of stress tests in 2009. The common equity capital ratio, which compares high-quality capital to risk-weighted assets, has more than doubled from 5.5 percent in the first quarter of 2009 to 12.5 percent in the fourth quarter of 2014 for the banks under review. This represents an increase in common equity capital of more than $641 billion to $1.1 trillion during the same period.

The banks, collectively, are projecting that they will continue building capital from the second quarter of 2015 through the second quarter of 2016. This is good news for consumers, businesses and investors. Banks have substantially finished their deleveraging and the restructuring of their legacy loans. This is especially true of the largest banks, though regional and local banks still may need to unwind some of their distressed assets. Banking profits have risen, with banking net income at $40 billion in the first quarter of 2015. Rising loan volumes and lower loan loss set-asides help banks increase their bottom lines. Banks see credit quality improving and increasing volumes are now being driven by business loans rather than mortgages.

Regional and Local Banks

Smaller banks tend to be dominant only in a certain region or city where they are based, so their growth is tied to the economic health of that area and its underlying business trends. They tend to be asset sensitive, so they make more money when interest rates rise. When looking at investment opportunities in this sector, we look for above average regional growth, loan growth, overall asset quality, a low amount of non-performing loans, high quality metrics in their loan book and how their loans are concentrated. In general, investors should favor a strong credit culture, which is easier to analyze in a smaller bank where loans are a more significant part of their revenue.

Investment Banks and Exchanges

Borrowing costs are low, balance sheets are strong and banks have ample cash to buy back stock, raise dividends or buy other companies. Such activity would benefit other parts of the financial sector, including investment banks that earn fees for M&A advisory services.

Another source of revenues for the investment banks is the initial public offering (IPO) market, which has heated up recently due to the level of the equity market and investors' appetite for risk. Firms like Morgan Stanley, Goldman Sachs, JP Morgan and Lazard Ltd. Management earn selling concessions for handling the IPOs, in addition to benefiting from the extra trading activity and volumes they generate.

Of course, increased trading volume benefits the exchanges these stocks trade on as well. At Rainier, we find some exchanges to be high margin, very attractive businesses with moderate competition. Intercontinental Exchange, for example, is the leading network of regulated exchanges and clearinghouses for financial markets, covering 12,000 traded contracts and securities across all major asset classes. The Chicago Mercantile Exchange is the world's leading and most diverse derivatives marketplace offering the widest range of futures and options products for risk management.

With an improved economy, Wall Street is also getting back into real estate lending in the form of debt securitization through commercial mortgage backed securities (CMBS). U.S. CMBS volume was $86 billion in 2013, just over $90 billion in 2014 and expected to be more than $100 billion in 2015. Fears of a refinance crisis in 2015-2017 have subsided despite the wave of CMBS refis coming in the years ahead. The market pricing rebound has helped alleviate that threat, but investors still need to watch out for assets in CMBS that are not refinanceable. As we saw in 2008, CMBS often take deals that banks and life companies won't touch—going for quantity over quality.

Asset Management Companies

The last two years have been good for the equity market, which means they have been even better for asset management companies. Asset managers have been riding the bull market to higher profitability and increasing their assets under management along the way. At Rainier, we like the investment opportunity we see in global asset managers like BlackRock and Affiliated Managers, which is comprised of 40 different money managers, covering equity, non-U.S. equity and alternative investments. The bull markets won't continue forever, but these asset managers are diversified enough to see growth even through a market downturn.

Insurance Companies

We have minimal exposure to insurance companies, as they tend to be more value-oriented and focus more on growth in book value rather than growth in earnings. There are exceptions in the space, such as AJ Gallagher, an insurance broker that plans, designs and administers property/casualty insurance and risk management programs. Insurance brokers are not as exposed to some of the weak pricing trends we've seen in other insurance-related businesses.

Financial Data and Service Companies

There are companies that provide information services to insurance companies and others in the financial sector, but are not seen as traditional financial companies. These include Verisk Analytics, which provides risk assessment and decision analytics to the insurance industry, and McGraw Hill Financial, which has business lines that include Standard & Poor's Rating Services, S&P Dow Jones Indices and J.D. Power. These are all attractive business models that include subscription services with recurring revenues. As a result, they tend to be higher multiple, higher growth stocks.

Real Estate Investment Trusts (REITs)

Commercial real estate fundamentals remain strong with very low levels of supply to meet the growing demand. The latest data on consumer confidence, jobs, debt ratios and capital flows suggest the U.S. expansion could continue for some time, which is beneficial for commercial real estate investments.

Due to their long-term performance, REITs should continue to see capital flow from both private and public sources. Historically, REITs can anticipate 3 to 4% dividend growth and typically deliver 3 to 5% yield to investors.

One trend to watch is the public to private conversion of REITs. Market conditions are ideal for these transactions. Low cost capital remains plentiful for now and debt underwriting standards have loosened. With investment yields compressed globally, REITs do not need to trade at as wide of a discount to net asset value (NAV) or require significant growth for returns to meet private buyers' objectives.

In addition to REITs, there are other companies in the real estate sector that we see benefiting from a tight commercial real estate market. Industry-leading companies like CBRE and Jones Lang LaSalle provide leasing and management services, as well as market research and property management to clients.

Financial Services Sector Outlook for 2015

Financial services touch nearly every aspect of our economy and comprise the second largest sector in the S&P 500, accounting for 16.2% of the index. The good news is that financials are clearly emerging from a long period of recovery. As the recent Fed tests show, the largest U.S. banks continue to build their capital levels and to strengthen their ability to lend to households and businesses. There is greater transparency in the system and better risk management in place. Despite uncertainties about the impact of an impending Fed tightening, we see ample investment opportunities ahead.

About Rainier Investment Management

The Rainier philosophy is simple. We invest in quality growth companies at prices that make sense. At Rainier, we believe that rewarding stock performance comes from companies with superior growth, attractive relative valuations, competitive strength, and financial integrity. Our decisions are based on fundamental analysis, which emphasizes bottom-up stock selection by sector specialists. We invest in all major market sectors because we believe that investment opportunities are found in industries that are frequently overlooked. Rainier remains focused on providing international equity, domestic equity, and fixed income portfolio management to financial advisors, institutional investors, and individual investors.

Top ten holdings as of 6/30/15 as follows:

Rainier Large Cap Fund	
Apple Inc.	4.4%
Citigroup Inc.	3.5
Walt Disney Co.	3.3
Allergan plc	3.2
Microsoft Corp.	3.0
Visa Inc.	2.9
Google Inc.	2.7
Sherwin-Williams Co.	2.6
Shire PLC	2.3
Home Depot Inc.	2.3

Rainier Small/Mid Cap Fund	
NXP Semiconductors NV	2.4%
Mohawk Industries, Inc.	2.2
Tyson Foods, Inc.	2.2
PDC Energy Inc.	2.1
MEDNAX, Inc.	2.0
Lazard Ltd.	2.0
James Lang LaSalle Inc.	1.7
Harman International Industries Inc.	1.7
Fortinet, Inc.	1.7
Minerals Technologies Inc.	1.6

Rainier Intermediate Fixed Income Fund	
JPMorgan Chase & Co.	4.0%
The Bank of Nova Scotia	4.0
Wells Fargo & Co.	3.9
Goldman Sachs Group Inc.	3.3
General Electric Capital Corp.	2.9
Hewlett-Packard Company	2.9
Westpac Banking Co.	2.5
Royal Bank of Canada	2.5
Bank of America Corp.	2.5
Morgan Stanley	2.5

Rainier Mid Cap Fund	
Mohawk Industries, Inc.	2.6%
NXP Semiconductors NV	2.4
Tyson Foods, Inc.	2.3
Lazard Ltd.	2.0
MEDNAX, Inc.	2.0
Devon Energy Corp.	1.8
Fortinet, Inc.	1.7
Southwest Airlines	1.7
Harman International Industries Inc.	1.6
James Lang LaSalle Inc.	1.6

Rainier International Discovery Fund	
Pigeon Corporation	2.5%
Ingenico Group SA	2.2
Dollarama Inc.	2.2
Techtronic Industries Co., Ltd.	1.9
Stroeer Media SE	1.8
Orpea SA	1.8
Eclat Textile Co., Ltd.	1.7
Essentra plc	1.5
Alps Electric Co., Ltd.	1.5
Wessanen NV	1.5

Rainier High Yield Fund	
Sabine Pass LNG LP	3.8%
Jefferies Finance LLC	3.7
Petrologistics LP	2.5
Aircastle Ltd	2.4
Griffon Corp.	2.3
MGM Resorts International	2.1
Calumet Specialty Product Partners, LP	2.0
Brightstar Corp.	2.0
Amerigas Finance	2.0
NewStar Financial, Inc.	1.9

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