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AMG - Q3 2018 Affiliated Managers Group Inc Earnings Call

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OVERVIEW:

Co. reported 3Q18 economic net income of $184m, GAAP EPS of $2.34 and economic EPS of $3.45.

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PRESENTATION

Operator

Greetings, and welcome to the AMG Third Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to our host, Mr. Jeff Parker, Vice President, Investor Relations for AMG. Thank you. You may begin.

Jeffrey Parker

Thank you for joining AMG to discuss our results for the third quarter of 2018.

In this conference call, certain matters discussed will constitute forward-looking statements. Actual results could differ materially from those projected due to a number of factors, including, but not limited to, those referenced in the company's Form 10-K and other filings we make with the SEC from time to time. We assume no obligation to update any forward-looking statements made during the call.

AMG will provide, on the Investor Relations section of its website, at www.amg.com, a replay of the call; a copy of our announcement of our results for the quarter; a reconciliation of any non-GAAP financial measures to the most directly comparable GAAP financial measures, including a reconciliation of any estimates of the company's Economic earnings per share for future periods that are announced on this call; and an investor presentation. AMG encourages investors to consult the Investor Relations section of its website regularly for updated information.

With us on the line to discuss the company's results for the quarter are Nate Dalton, President and Chief Executive Officer; and Jay Horgen, Chief Financial Officer.

With that, I'll turn the call over to Nate.

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Thanks, Jeff, and good morning, everyone. Against a challenging industry backdrop, AMG generated solid results in the third quarter of 2018, including positive net client cash flows of approximately $1 billion and Economic earnings per share of $3.45. Our results reflect the diversity of our global business and our strategic position in attractive, return-oriented products, where we continue to see significant client demand for our Affiliates' strategies and the distinctive investment return streams they create.

In terms of third quarter flows, we saw continued strong demand for alternatives, which included another quarter of very significant illiquid product fundraising from institutional clients, partially offset by softness in liquid alternatives in the retail channel, where investors tend to be more sensitive to short-term performance.

The ongoing strength of our alternative products was partially offset by net outflows from equity strategies, driven primarily by emerging markets products and U.S. equity retail outflows.

At the highest level, we were pleased with our positive organic growth in the third quarter despite industry headwinds. We benefited from having built a diverse, global business and we were pleased to see a very broad array of product types, Affiliates and geographies contributed significantly to our flow composition as we saw strong sales across Baring Asia, BlueMountain, Capula, EIG, Pantheon and PFM within alternative category; while Artemis, Frontier and Harding Loevner were notable contributors within our equities category.

Looking ahead, I want to address the current market environment and how we have built and continue to position our business. Obviously, it's been a volatile period. Global and U.S. equity markets have declined roughly 10% month-to-date as of Friday and frankly, that understates some of the underlying vol we have been seeing. Anecdotal evidence point to some de-risking in this environment, and you can see that reflected in this month's retail flow data.

In the short run, this obviously creates challenges in various segments of the asset management industry. But in terms of AMG, we have been evolving the business in anticipation of more volatile and fundamentals-driven market, where the highest-quality active managers prove their worth. Volatile markets underscore the need for investors to diversify their equity and fixed income exposure, especially when markets are at elevated levels. Finally, within both traditional and alternative categories, volatile markets create environment with the best active managers, like our Affiliates, can significantly outperform their benchmarks in simple passive products.

Looking ahead, I would focus on three aspects of our business and strategic position; (1) the diversity of the business we built over the years; (2) the opportunities for the best active managers to outperform in this environment; and (3) the quality of our Affiliates and the distinctive return streams they produce.

First, on the diversity of our business. Over the last decade, we have deliberately doubled the proportion of our business in alternatives from approximately 20% in the beginning of 2008 to approximately 40% of assets under management today spread across a very diverse set of high-quality alternative products, while increasing our exposure to growing parts of the client portfolios at a highly active alpha end of the barbell. This evolution has come from both investment in non-affiliates as well as product innovation and development by us and our Affiliates.

Our alternatives business now has approximately $320 billion in assets under management, making AMG one of the largest alternative managers with one of the broadest and most diverse ranges of liquid and illiquid alternative strategies, managed by leading investors, including AQR, Baring Asia, BlueMountain, Capula, EIG, First Quadrant, Pantheon, PFM, Systematica, ValueAct and Winton.

In addition, our substantial exposure to uncorrelated alternative strategies should increase the stability and resilience of our business across market cycles, while, most importantly, proving attractive to clients, so increasing the long-term organic growth potential of our business.

Second, turning to the opportunity for active management. In general, we have found that volatility is good for active managers (as opposed to steadily rising indices driven by capital flows). Simply put, a shift to the more fundamentals-driven market provides a more favorable environment for the highest quality active managers, such as our Affiliates, to distinguish themselves.

You can see this in the data from our recently updated study called the Boutique Premium, which we'll be reissuing shortly. The broad findings remain the same as when we first published the paper in 2015, primarily that boutiques outperformed both non-boutiques and market indices over most long-term periods. Importantly, the data also shows that the outperformance advantage of boutiques was most significant during more volatile periods in the markets. This stands the reason as the element to drive superior alpha generation by boutiques in the first place, including investment-led entrepreneurial culture, meaningful equity ownership by the investment professionals and the long-duration alignment with clients and partners -- all support a long-term perspective, which encourages these firms and their investment team to maintain their investment processes through volatile periods.

Now turning to the third theme, quality and expanding high-quality products. Our Affiliates have outstanding long-term track records of investment performance and attractive return-oriented areas. As you know, especially for institutions, medium- to long-term performance over 3, 5 or even longer periods is important in determining manager selection. Our global equities and alternative strategies, both liquid and illiquid, have excellent long-term investment performance records. For example, approximately 70% of our global equities assets and over 85% of our liquid alternative strategies are ahead of benchmarks over the last five years.

While volatile environments contain challenges, they also bring opportunities --and we and our Affiliates have been innovating and developing new products with diverse distinctive return streams, which is, of course, critically important to match evolving client needs. Today, we continue to work closely with our Affiliates to invest together in those products, packages and distribution capabilities, we believe will provide the highest growth potential.

Now we haven't just diversified products, but also clients. We have taken a business that was mostly U.S. clients and successfully expanded our client base, both through our Affiliates' business development teams as well as through our global distribution platform -- where we first opened an office in Australia and then expanded to the Middle East, Europe and parts of Asia, including Hong Kong and now Japan. Today, our global business represents a balanced mix between U.S. and non-U.S. clients.

In the third quarter, we again saw the benefits of diversity in our global distribution strategy, as we generated positive net flows across each of our institutional coverage regions.

Looking ahead, while there may be short-term volatility, our unique distribution strategy, which combines the focused distribution resources of each of our Affiliates with a leveregable scope and scale of AMG's global distribution platform is increasingly effective as leading clients worldwide and the intermediaries who serve them are consolidating their relationships with external managers and looking for more effective relationships and even partnerships with a smaller universe of investment management firms.

Now in addition to these elements of organic growth in our existing business, we have another proprietary growth engine. AMG's business model provides a significant opportunity to generate increased earnings growth as well as product diversification through accretive investments in new Affiliates.

AMG's equity ownership succession solution is very effective to asset management boutiques that value their independence, want a permanent solution and access to the scale distribution platforms we have built. Every boutique will inevitably have to address their permanent succession issues and we continue to actively develop our proprietary relationships with leading boutiques and, while the pace of activity is inherently based on the dynamics of each prospective Affiliate, we're making meaningful progress with our pipeline, while we remain focused on high-quality new prospects and discipline on pricing and alignment, particularly at this stage of the market cycle. While maintaining the financial flexibility to invest in accretive new Affiliates and continuing to execute on the other elements of our growth strategy, we also remain committed to consistently returning capital to our shareholders. As Jay will discuss further in a moment, we demonstrated this discipline approach to capital allocation again in the third quarter.

Looking ahead, we are very confident in our ability to continue to enhance the quality, diversity and earnings power of our business and generate outstanding long-term shareholder value. For our unique business model, we offer a diverse array of excellent, focused specialist managers, along with the scale and resources of a global asset management franchise, combined with a 25-year track record of deploying the cash flow generated by our business to create shareholder value.

With that, I'll turn to Jay to discuss our results in more detail.

Jay C. Horgen - *Affiliated Managers Group, Inc. - CFO & Treasurer*

Thank you, Nate, and good morning. As Nate discussed, we were pleased with our third quarter results, which included positive organic growth against the backdrop of industry headwinds. As we enter the fourth quarter, we believe AMG is well positioned for an evolving macro environment, as heightened volatility and risk aversion creates opportunities for the highest-quality active managers, such as our Affiliates, to distinguish themselves.

The scale and diversity of our business across asset classes, client channels and geographies, the quality of our alpha-oriented product set and the unique structure of our partnerships with Affiliates, together, enhance the stability of our cash flow. And given our business strength and resilience, we are able to execute on our growth strategy throughout market cycles.

Before turning to the quarter, as Jeff mentioned, we have posted the investor presentation on our website this morning under Investor Relations quarterly results. Going forward, we will be providing this updated presentation simultaneous with our earnings release, so that we can refer to certain information during our call.

I would like to call your attention to the incremental information we have provided this quarter in response to investor feedback back. On Page 9, we've included aggregate investment performance for global and U.S. equity products as well as liquid and illiquid products, which, we believe, best represents our long-term track records for these categories. I will be referring to this information in just a moment.

In addition, on Page 17 of the presentation, given that we are including selected composites for each product category through the first 3 quarters of 2018, I will no longer restate this information in my prepared remarks.

Now turning to the details for the quarter. Starting with alternatives, which account for 39% of AUM, we had a strong quarter of organic growth with $4.5 billion of net flows and saw meaningful positive contributions from our illiquid product set, partially offset by outflows in our liquid alternatives in the retail channel.

Focusing on illiquids, which include strategies, such as global and regional private equity, co-investments, credit, real assets, infrastructure and real estate, we had an excellent level of fundings in the third quarter, which drove our flows. And we continue to expect more fundraisings from flagship funds and scalable product line extensions as we look forward.

As you can see on Page 9 of our investor presentation, AMG's aggregate performance in illiquids is very strong with 92% of our recent fund outperforming industry benchmarks on a net IRR basis and 79% outperforming on a net multiple basis.

In our liquid alternatives category, encompassing our multi-strategy fixed, income and equity relative value and systematic diversified strategies, while we experienced an outflow in the retail channel, where clients tend to be more sensitive to short-term performance, we saw a positive overall institutional flows into liquid alternatives across a broad array of products. And while AMG's aggregate performance in liquid alternatives was challenged in the quarter year-to-date, our long-term investment performance remained strong, with 71% and 86% of assets under management outperforming their benchmarks over a 3- and 5-year period, respectively.

Before I leave alternatives, as Nate discussed, October's sharp reversal on equity markets highlights the importance of diversification and the benefits of alternatives and client portfolios. We have seen this diversity play out for us, as our alternative strategies have generated meaningfully better performance than equities in October with the alternative portion of our market composite, as of Friday, down only 2% relative to broader market equity markets, which were down approximately 10%.

Now turning to equities. In the global equities category, we saw net outflows of $2 billion in the quarter, primarily from emerging markets in global retail products. AMG continues to have strong long-term aggregate performance in this category with approximately 70% of our assets under management ahead of benchmark on a 5-year basis.

In U.S. equities, we reported now net outflows of $1.7 billion. And while negative overall, we continue to see pockets of ongoing opportunity, while, at the same time, we are seeing lower levels of redemption. While AMG's performance in U.S. equities continues to be challenged relative to benchmarks over a 3- and 5-year period, we believe a continued shift to a more fundamentals-driven market environment will improve relative performance.

Now turning to the multi-asset and other category, which accounts for 13% of our AUM and encompasses multi-asset and balanced mandates within a wealth management business, as well as a number of specialty fixed income and multi-asset products. Here, we posted another positive quarter with $0.1 billion in net flows as demand trends remain in place for wealth management business. While we have seen some weakness in our legacy fixed income products, our new products in this category are generating good momentum, especially within systematic fixed income.

Finally, turning to our quarterly flows by distribution channel. We saw significant strength within institutional, which represents 58% of our AUM, where we had $5.7 billion in net flows, driven by alternatives, especially from our illiquid fundraisers.

In the retail channel, which represents 28% of our AUM, we had net outflows of $4.9 billion, where we saw weakness in liquids alternatives, driven by recent performance combined with continued outflows in U.S. equities.

Finally, in the high net worth channel, which represents 14% of our AUM, we reported positive net flows of $0.1 billion where the underlying demand trends remain in place.

Now turning to our financials. As you saw in the release, Economic earnings per share increased 1% to $3.45 for the third quarter, which included net performance fees of $0.03. On a GAAP basis, we reported earnings per share of $2.34.

For the third quarter, Aggregate Fees were flat at $1.3 billion from a year ago, while the ratio of Aggregate Fees to average assets under management declined year-over-year from 64 basis points to 61 basis points, which was driven, in part, by a lower level of performance fees and changes in the composition of our AUM.

Adjusted EBITDA decreased 7% to $237.8 million from a year ago, primarily due to lower other income, a couple of nonrecurring expenses and investments that we made together with our Affiliates in product development and distribution.

Relative to EBITDA, Economic net income decreased 4% to $184 million from a year ago, reflecting lower interest expense and a lower tax rate, while Economic earnings per share grew 1% to $3.45 given lower year-over-year share count due to repurchase activity.

Turning to more specific modeling items. For the third quarter, the ratio of adjusted EBITDA to average assets under management was 11.4 basis points or 11.3 basis points, excluding performance fees.

Looking ahead, we expect adjusted EBITDA to average assets under management to be 12.4 basis points in the fourth quarter, reflecting a net performance fee assumption of approximately $0.40 as well as continued investment in product development and distribution capabilities.

Our share of interest expense was $19.6 million for the third quarter. In the fourth quarter, we expect our share of interest expense to remain at approximately $19 million.

Our share of reported amortization and impairments was $44.9 million for the third quarter, including $22.2 million from Affiliates accounted for under the equity method.

Looking ahead to the fourth quarter, we expect our share reported amortization and impairments to be approximately $42 million.

Turning to taxes. In regard to our tax rate in the third quarter, our effective GAAP tax rate was 27%, and our cash tax rate was 19.9%.

In the fourth quarter, while we expect our GAAP tax rate to be approximately 26%, we expect our cash tax rate to be impacted by a onetime benefit in the fourth quarter in the range of $20 million to $25 million, primarily from the final disposition of Ivory. Excluding the nonrecurring item, we expect our cash tax rate to be approximately 19% going forward.

Intangible-related deferred taxes were $12.2 million in the third quarter. For the fourth quarter, we expect intangible-related deferred taxes to be approximately $13 million, excluding this nonrecurring item.

Other economic items was $2 million for the third quarter. For modeling purposes, we expect other economic items to be approximately $1 million per quarter.

Our adjusted weighted average share count for the third quarter was 53.2 million, and we expect it to be approximately 52.6 million for the fourth quarter. And we now expect our adjusted weighted average share count for the full year to be approximately 53.7 million.

Turning to our balance sheet, in the third quarter, we paid a $0.30 per share dividend, and we repurchased $113 million in shares. Looking to the fourth quarter, while we expect to repurchase approximately $100 million, the amount and timing will depend on market conditions and potential new investments.

Taking a step back, over the past decade, we've prioritized flexibility as well as the reduction of balance sheet leverage, which gives us ample capacity. Given that capacity, today, we are well positioned to both deploy capital for a full market cycle, as we execute on our growth initiatives and deliver on our commitment to consistently return capital to shareholders.

Now we'll be happy to answer your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Michael Carrier with Bank of America Merrill Lynch.

Michael Roger Carrier - *BofA Merrill Lynch, Research Division - Director*

Maybe first question just on the alternatives. So clearly, from a flow standpoint, you guys have been doing well. It seems like on the performance, and whether it's you guys or the industry, things have been a bit more muted. But I guess, just want to get your sense on when we we see the good growth coming in alternatives, how does that impact the outlook in terms of ENI, so whether it's ownership and how that can potentially impact the fee rates or even performance fees when you're in an environment, where it's obviously weaker in maybe the long term trend?

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Great. So thanks for the question. It's Nate, and I'll start and then ask Jay to pick up the second half. So I think the most important thing when you think about our alternatives business, if you will, is it really breaks into a number of different categories. So in the materials we posted on our website, we broken it into 4 groups. And they behave differently, and we're having different experience within them, which, I think, points to the benefit of the diversification that we've built. So for example, we have a private equity and real assets category, which includes infrastructure and private credit and other things, and that business is behaving one way, in which, right now, there's an incredible amount of demand. There's really good sort of product development going on. The take-up through our distribution and through our Affiliates' own distribution is fantastic. And so that part of the business, and both Jay and I talked about how that's a part of our flow profile right now, but that's something we also just see continuing to grow and, importantly, diversify as well. And when you talk about how that flows through, obviously, the performance fee or carry piece of that is, of course, growing. But it's certainly something that grows out into -- kind of starts 2, 3 years out and grows kind of thing. So that's kind of one part of the book. Then in a more what we talked about sort of more liquid, we have sort of a fixed income and kind of relative equity relative value book, and that's a business line that generally had, industry-wide, that's had kind of more muted returns for a while. But I think in these volatile environments, that's performing reasonably well. I think that the multi-strat business, not an entirely different story, which is it's been kind of muted returns and clearly, how will that perform going forward. And then we have a systematic diversified business, which you've heard us talk about us having kind of more challenge performance for a while now. And then in the current environment, again, it's a kind of thing that you would expect, at least, has the opportunity because it contains so many kind of uncorrelated positive expected return streams. There'll be opportunity to perform. So I think we're very bullish about the fact that we've both diversified the equity business, including all these, as you heard us talk about, but then also the diversity we've built within this, which, over time, should provide stability to a bunch of different alternatives, including the flow profile as well as the earnings profile. I don't know, Jay, if you want to...

Jay C. Horgen - *Affiliated Managers Group, Inc. - CFO & Treasurer*

I'll just pick up and talk about the ENI impact. And starting with a calendar year, any one calendar year, it can be hard to predict, in part, because of the performance fee opportunity in that calendar year. But if you think about it, just in -- over time, the ENI impact of raising more alternatives is generally a positive thing. The management fee typically is higher. The performance fee opportunity, as Nate said, in the privacy equity vehicle, that tends to build over time, and we're seeing that happen for us. Remember, we are on method one, so we only report that when it crystallizes. So we are seeing the mix shift longer term be a positive ENI benefit to us. But again, in any one period, it's a little harder because it depends on which one, what the ownership level and what the performance fee is. But I think the best outlook for us is that this private equity and alternative build will play out on our ENI over time.

Operator

Our next question comes from the line of Craig Siegenthaler with Crédit Suisse.

Craig William Siegenthaler - *Crédit Suisse AG, Research Division - MD*

I just wanted to start with a big picture question, business model question, which is actually sort of 3 parts, so I'll jump back in the queue after this one. But just given the evolving industry backdrop, what do you view as the main benefits now of the multi-boutique model? Also how has AMG's business model evolved over the last 5 years? And more importantly, can you remind us the different ways you can leverage the benefits of scale for your Affiliates?

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Thank you very much for that question. I'm glad you asked because I think first, I'm going to speak mostly to our business rather than multi-boutiques or maybe wholly to our business as opposed to other multi-boutiques because I really do think our business is different in some fundamental ways. And so let me start there, which is, if you think about AMG today across our Affiliates, we have incredible level of diversity, and we talked about this in the script, incredible level of diversity. That diversity is of distinctive return streams. So each of our Affiliates is independently producing these return streams. And we believe there's a level of excellence to that, and we talked about that in terms of some of the performance items. So you have diverse, distinct, excellent manufacturing. But then the thing that I think is different about our business is we've been able to achieve that diversity and the scale without having to combine or compromise Affiliate cultures, right? So each of our Affiliates is a truly distinct business, which, we think, is really important from the standpoint of the manufacturing of return streams. That is a place, where, generally, on the active side, alpha scale is not a benefit. So diverse, distinctive, excellent manufacturing, we've achieved that scale without having to combine or compromise cultures. And then, again, really important thing to understand is we can continue to add to that scale significantly without having to compromise cultures, right? So it's not just that we have a business model that allows us to manage that diversity today, but because of the way we have built it, we're able to continue to add to that scale without, again, combining or compromising cultures. And I don't think there is another business that manages that level of diversity and scale without compromising cultures. Others may be as large on an asset basis, but not with that same of level of diversity, that really distinct diversity underneath with different cultures. So I think that's a very important point I would hope people internalize.

The second piece, which I would go through -- which I think is really more your third question, but also picks up some of the evolution. And the real challenge for us, and I think for other multi-boutiques, is how do you bring -- or how do we bring that diverse excellent scale to bear effectively for clients and intermediaries. So I think that's the challenge. And here, I'd make a couple of points, right? So first, each of our Affiliates very effectively brings their products or services to some markets segments and some geographies very effectively by themselves, right? And that's -- sort of you're looking backwards, that's -- in part, what's attracted us to them in the first place, and you've heard us talk a little bit about what we look for in high quality going forward as well. So each Affiliate does it very effectively themselves. But there are lots of ways to leverage our scope and scale to more effectively bring the products to different geographies and market segments. And we, obviously -- for more than a decade now, we've been building out our global distribution platform, we think in a pretty differentiated way. That is an example where we can leverage our scale in a very flexible way for the benefits of our Affiliates, and we've got proven success now again, so we've been building those for over a decade. I do think -- and this goes to your last 5 years' point of it -- I do think we are making investments not just in building out regional distribution, but also in packaging and distribution, operational capabilities as well. And we've talked about that on some calls in a couple of different ways. So one is, I think on the last call, we spent some time talking about how we're doing that in bringing illiquid product into DC and retail. And we talked about working with -- excuse me, with an Affiliate to build a 40-Act fund or to build a CIT. This past quarter, we closed -- and the dollars were not -- the dollars were modest, but we closed our first kind of feeder fund, sold into -- by one of our Affiliates sold into a large broker-dealer in the U.S. So we're building those capabilities. And these are just examples. I mean, we've talked about the Japan a bunch last quarter. These are examples of how we're continuing to extend what we've done with our global distribution platform for the benefit of our Affiliates. And again, we're doing it in a very flexible way that allows us to leverage the scale without interfering with those unique cultures. And again, I think we do that at a significant scale, which allows us to get to the level of diversity that we talked about before. Maybe I'll add one more to it, which, again, goes to what have we been doing recently and how will we take this forward, which is, you've heard us talk for a while about this trend of clients and intermediaries trying to consolidate relationships. And that's much more efficient for them as they're trying to manage their business. And I think, again, because of the diversity and scale, we're at a place where if we do this well, they can get access to all of this manufacturing in a very efficient way. And this is something that we've been working on for a while. So the example I'd add is this past quarter, we entered into a memorandum of understanding with a large European financial institution to take the next step in doing that, which is bringing our Affiliate products to market using our manufacturing combined with their packaging and distribution, although, obviously, we have to support the distribution as well. I don't want to make a big deal out of this because it's not really going to start -- we don't think products will start coming online until kind of Q1 2019. But it's an example that we're continuing to work to find more and more effective ways to bring all of that kind of excellent, diverse scale. Again, truly diverse, not just different product teams, but, really, people who maintain their own very independent cultures, bring all of that to bear for our Affiliates. And so I think, for us, that's the competitive advantage of our business model, which is the ability to gather all of that excellent diverse manufacturing and then add to it by being able to bring some of the benefits of scale to bear.

Operator

Our next question comes from the line of Alex Blostein with Goldman Sachs.

Alexander Blostein - *Goldman Sachs Group Inc., Research Division - Lead Capital Markets Analyst*

I was wondering if you could comment on the buyback and capital return priorities here. So it's a bit in line, I guess, relative to the pace you guys have bought back stock in the first part of the year. Why the pullback? Jay, I think you -- I heard you say another $100-ish million in Q4 given the valuation of the stock and no near-term deals feels like we would expect that one more from you guys. So just some color on that will be helpful.

Jay C. Horgen - *Affiliated Managers Group, Inc. - CFO & Treasurer*

Yes. Thanks, Alex. So yes, you characterized it as a pullback, but I don't think it's a pullback at all. In fact, the last 8 quarters, I think we've probably averaged about $100 million. So it seems right in the zone of where we've been. In fact, it's a little more than that -- it's $113 million, so a little more than $100 million. But just taking a step back, just making a couple of comments here. We're mindful of the market volatility -- market for our stock, but also market volatility. We also, as you heard Nate say, we're investing in both new initiatives. But also we're optimistic about our new investment pipeline, and that was in my prepared remarks. I think we're being mindful of that. We're always committed to a disciplined allocation of capital, which, really, includes balancing these growth initiatives with capital returns again -- against the backdrop of an appropriate leverage ratio, so that we can invest through a cycle. So I don't think anything is different, but we have always been committed to a capital return strategy that balances all of those initiatives.

Operator

Our next question comes from the line of Bill Katz with Citigroup.

William R. Katz - *Citigroup Inc, Research Division - MD*

Okay. And to stay on that capital management thing for a second as well. Just maybe broaden it out. Can you step back a little bit and talk a little bit about how your capital management is evolving against a couple of things? Number one, just so the shifting of the sort of asset management ecosystem and is it still sort of credible to continue to go after sort of midsized players at this point in time, number one? And then just sort of given the -- what looks to be some pretty elevated multiples in the private market, how you're thinking about that versus buyback right here.

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Maybe I'll start just on the part of both the questions and a little bit the prior, which is how we're thinking about the M&A environment because I do think -- I don't disagree with some of the dynamics. But -- and to answer your question with both just what kind of firms are we looking at and then also how we think about the pricing, so maybe it would be useful to just level set on that one. And so, look, we've been running this basic model and approach for, now, almost exactly 25 years, which is being try to build a business where the best institutional partner to these excellent boutique firms. And I don't think that strategy changes. And I also think, generally, the firms we're partnering with are not trying to do a trade or whatever, but the firms who are trying to partner with us are the ones that are really trying to pick a permanent institutional partner. And so that's -- I don't think that's changing at all. Now of course, we're being disciplined. And here, I agree with part of what was in your question, which is -- your commentary on some prices that have been paid. And look, when we're looking at new investments, we're disciplined across a bunch of different dimensions, right? We're disciplined across the quality of the business, and we talked a little bit about that last quarter, but that was a bunch of different component parts just as we're very disciplined about the quality of the business that we're looking at. We're very disciplined about, "Can we get the right long-term alignment with the principles of the business?" And of course, we're very disciplined on pricing. And so implicit in both this question and I think a little bit of the prior, when we're talking about this discipline, we're measuring this -- as Jay said in a prior answer, we're measuring this against the opportunities to invest on our business, either in the operation of our business or the shares of our business. So I think we're looking at all of those as -- when we say discipline, I think we're putting all those things into it. All of that said, we think there's an outstanding -- there continues to be an outstanding secular opportunity to partner with the best boutique firms. And look, as we always say, the timing of investment is driven by the dynamics. And as I just said, most boutique firms don't have to do anything at any specific point in time, but also neither do we. And so, look, we're making good progress in these things we're looking at. And fundamentally, I agree with the part of your question, which is looking at some of the prices I think there are definitely questions there. So maybe I'll add just one more thing, and I don't know, obviously, whether the volatility we're experiencing continues or not, but the only thing I'll say is I think our experience has been, in prior volatile periods, the volatile times are good for us as a competitor in looking at -- making investments because the strength, scale, track record, importantly, as I said, 25 years, are more important than ever as prospective Affiliates focus on the partner that they're bringing on board as a potentially permanent partner. And so that's the way I would characterize it today. And so I think -- put aside one quarter here or there, I think the secular opportunity for us to continue to invest in just great manufacturing businesses, great boutique Affiliates, I think, is as strong as ever.

Operator

Our next question comes from the line of Chris Shutler with William Blair.

Christopher Charles Shutler - *William Blair & Company L.L.C., Research Division - Research Analyst*

I think, Nate, in the prepared remarks as well as in the press release, you continue to use the word proprietary a lot when talking about the pipeline, but we've seen a number of deals, particularly in the alt space and others are using, I think, the phrase permanent capital partner as well in talking about their strategy. So would love to get any comments there and confidence on how proprietary the pipeline really is.

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Yes. So look, I'd say a couple of things. So first, we do have a proprietary effort. I think the -- you should also assume we're looking at all the transactions that are in the marketplace as they go. And I'd probably just refer to my prior answer, which is, look, some of those businesses don't make any sense for us, as they're predicated, for example, in bringing together overlapping capabilities, whatever, and that one category sort of the cost cutting consolidation kind of thing, but the other -- we are remaining disciplined across all of those dimensions I talked about. And there may be or have been firms where you look at them and you say, "Well, that meets that discipline on one of those dimensions, but not on other dimension." And so we are staying disciplined. On the permanent point, I think -- and I don't want to comment specifically about one model here or there, but on the permanence point, I think it's that -- they are unproven models. And I think, here, I would point you to the fact that we've been running effectively this business of being permanent institutional partners to great boutiques for 25 years through full cycles. And I think some of those models may not have thought through all the different elements of that. But again, I'm not commenting on any one here or there, but I think that is certainly something we see.

Operator

And our next question comes from the line of Dan Fannon with Jefferies.

Daniel Thomas Fannon - *Jefferies LLC, Research Division - Senior Equity Research Analyst*

My question is around flows and just kind of the outlook. First, I've appreciated the increased disclosure on performance. But I guess, as you think about October, the derisking, I think, you mentioned, can you talk about any change in client behavior? And in particular, if you could address AQR, which is, I think, a focus for a lot of investors given its size and contribution to you in terms of -- we've seen a slowdown in retail and how we should think about that for the larger component of institutional and whether you, as a firm, in aggregate can still post -- you can still post inflows if AQR is, in fact, in a bit of a struggling period.

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Yes. So let me start here and then maybe I'll try to pick up some of the pieces. But look, on your specific question, I would just say look at the diversity of the business that we've built. And AQR is certainly an important part of our business -- very important part of our business, but it's a part of our business. And so I'll just point you to the quarter we just had. But let me address specifically your fourth quarter comment, which is I'll make a couple of observations. So first, at the high -- at a high level, the trends remain intact, right? So we continue to see good illiquid fundraising, especially institutional, some retail. And we do see continuing challenging retail liquid alt flows. I think those trends will remain intact. As I said, I do think the volatility that we're experiencing and have, at least, experienced will have -- is having a short-term effect on some clients, those slower decision process. I think that's -- again, the reason shouldn't be surprising. And then I would just remind folks, I think that kind of Q4 is just generally a seasonally weak quarter. We've talked about selling and the kind of Q4, Q1 effect that we've talked about before on single-year and multi-lock vehicles. But the -- in terms of the overall positioning, and I'll come back to the first point on AQR's overall positioning, the Affiliate performance, and Jay talked about this, is good. The pace of innovation is really good, both new strategies and extensions of existing strategies. The pace of activity in distribution, packaging, geographies, channels is really good. And I think we're increasingly effective at bringing Affiliates into engine markets, channels and into places that are looking for more efficient ways to get access to all this manufacturing. So I think all of those trends remain in place. I mean, Jay...

Jay C. Horgen - *Affiliated Managers Group, Inc. - CFO & Treasurer*

I was just going to pick up on the one component of the conversation, which is just how does it translate into earnings and contribution. And I think here, Nate already said it, diversity is really important. It's always been important to us. And I want to make sure we're not confusing a period of time where we have a little bit of soft performance fee outlook in the calendar year that we're in as opposed to the long term. So as it relates to the earnings profile, we do see AQR, but a number of other large Affiliates continuing to contribute at a really high level to us. And in any one year where we have a lower performance fee contribution, it really in no way diminishes the long-term value of that performance fee stream. So I think, on an earnings basis, it might get conflated. But really, AQR is strong, so are a number of our other largest Affiliates. And of course, we're in this period of time where we're seeing a lot of follow-through from the illiquid private equity style, and that's just building a future sort of pipeline of carry and additional earnings into the future.

Operator

Our next question comes from the line of Robert Lee with KBW.

Robert Andrew Lee - *Keefe, Bruyette, & Woods, Inc., Research Division - MD and Analyst*

Maybe Nate, Jay, I'd like to go back to the M&A topic a little bit. So as you think about the investment landscape, how -- what's maybe changed, whether in terms of size or scope or capabilities of the prospective Affiliates you're looking at maybe over the last couple of years? I mean, no, not to pick on, say, Ivory, but relatively small firm came as part of, I guess, a multi-boutique acquisition in a way. But how do you think about kind of the size or type or scalability of the Affiliates you're interested in versus maybe what you used to look at or would be willing to do several years ago?

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Thanks for the question. So we talked a little bit, I think, on our last call about this. How do we -- what do we mean when we say high quality? And I think you've captured many of the elements, which is -- which are, we're looking for firms that we think have the ability to grow in this environment and the environments we expect to come. Some of that is the orientation of the principles of the firm, right? What are they trying to achieve? Some of it is, what can they achieve on their own? And some of it is, what can we do together? And so I think we are looking for more complete firms, I'll say it that way, in terms of orientation to grow and evolve the capability set that allow them to grow and evolve. But we're also still attracted to firms that are really doing one thing, they're doing it very, very well, but we have the opportunity, and this is the part that, I think, has evolved a bit over the past couple of years. We have the ability to work with that firm in ways that are additive to the whole. And so I think we talk about high quality as either that kind of more complete firm or something that, together, we can grow and evolve, and it's additive to the whole, whether it's client dialogue or what have you, as well. And so I think it also relates a bit to the prior question, which is, "Well, how will that manifest? What does that mean?" And so we do have a set of proprietary relationships. Our pipeline includes conversations that we've been having, in some cases, the better part of a quarter century. And we're building relationships, maintaining relationships, evaluating these firms. And we're looking at them through the screen of the evolving landscape that we're seeing. One other point that I'll make here is as we've been growing our distribution platform, as we've been having dialogues with intermediaries and then clients who are already or might use multiple Affiliates, we're getting better and better at certainly the near side of the demand characteristics we should be looking for, but we think also strategically understanding what these intermediaries or what these end-users are looking for as they're trying to solve their evolving challenges over time. And that just makes us better as we're looking on the front end for prospective new Affiliates. And this is something that we're still in the early stages of, but we are getting a better and better at all the time.

Operator

Our next question comes from the line of Brian Bedell with Deutsche Bank.

Brian Bertram Bedell - *Deutsche Bank AG, Research Division - Director in Equity Research*

Great. Maybe I think, Jay, to circle back on the coming quarter and the fourth quarter, can you talk a little bit about the performance to date? I know the alts are doing relatively well. We're measuring about negative 7% on the mutual fund side. I know that's overstating the downside given your alt mix, so maybe you can talk about it on a firm-wide basis. And then on the fee rate, I think your guidance included the $0.40 of performance fees. Is that -- if I'm calculating it right, is that about a stable fee rate ex the performance fees around $11.4 million, $11.5 million?

Jay C. Horgen - *Affiliated Managers Group, Inc. - CFO & Treasurer*

Thanks, Brian. So I'll take your last one first because that's an easy one. Yes, it's $11.3 million, $11.4 million, so that's stable to the last quarter. That's it, that's an easy one. Maybe I'll take a step back and kind of wrap altogether the guidance that we gave and also include kind of where we are on mark through last Friday. So I mentioned in my prepared remarks that the portion -- the market deposit for the portion that is alternative book is down about 2%. For equities, it's approaching 10%. That blend with multi-asset in there, as well, is about 5.5%. So yes, it's much better than the 7%. I think it speaks to the diversity, and I suspect we're doing better than some of our peers or maybe most of our peers in that regard. Obviously, that will have an impact on the fourth quarter, but it has more of an impact on a full year basis as we already begun the fourth quarter. The guidance, specifically, on performance fees, maybe I'll step back for a moment and just talk about guidance from our last call to this call on performance fees, which has changed a bit and, specifically, it's around a beta-sensitive product. They were tracking to a much higher potential contribution for the year for us. And in the last call, we also mentioned that certain of our less correlated products, including many of the systematic products were at or below high water mark, were not expected to give us a contribution in 2018. Interestingly, given the significant equity market pullback and the increased volatility in October, we've seen a sharp reversal of these trends affecting our fourth quarter performance fee opportunity. On the one hand, we've reduced our expectation for the beta-sensitive performance fees. But on the other hand, we're more optimistic about the improvement and investment performance at our less correlated products. So we may be too conservative here with the $0.40. This has all happened in the last few weeks, but I think seeing those trends, it will take a little more time for our less correlated products to -- now that they've improved significantly, it'll take some time for them to really generate more performance fees, so we see the outlook for 2019 much improved in that regard. And there may be enough performance in the fourth quarter, where this number is conservative.

Operator

Our next question comes from the line of Patrick Davitt with Autonomous Research.

Patrick Davitt - *Autonomous Research LLP - Partner, United States Asset Managers*

Some other managers have been highlighting a still very strong institutional demand for global and emerging market strategies through the rally we saw and even into October. I'm curious if you're seeing a similar trend. And within that vein, as the value has started to outperform, are you seeing increased demand for value equity in the U.S.?

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Yes, let me take that. So I do think we have -- we've been saying good demand trends, generally, in -- sort of the high focal point is the demand trends, generally, as our impression, in sort of remaining intact, which include demand trends for global equities. I think on the EM side, I don't know. I mean, it's harder for me to see that. We have a narrower product set there -- and so I think our judgment is much more idiosyncratic to us. I think the point you make on value is a really good one, and I'm glad you raised it, which is -- included among our Affiliates are some just world-class value equity managers. And again, in a long time, right, that value growth disparity that we can talk, of course, about various reasons for it. But we really believe that if we get to or if we are in a more fundamentally driven market that the value managers we have will have the opportunity outperform significantly and also open up and take on new flow because I think the challenge, just generalizing it, but the challenge for many of them was finding enough good opportunities to put capital to work. And so we've had either actually closed or not just -- people who are not really marketing a product, they have the challenge where they had to put their existing client assets to work first and had reasonably high cash levels as well. And so whether you look at like Yacktman, who, I think, is the #1 performing -- I think 2 of their funds -- are #1 or 2 something, performing funds in their category or the Tweedy Brown funds that are now top quartile. So I mean, like, we have just great value managers there. And so if that market evolution were much more value heavy on -- certainly on our U.S. equity side, but even including in our global category, and so if that evolution is happening, that absolutely plays well for us. And we've seen it in certainly -- and these are all just early days and all that, but we've seen it in slowing outflows, in a little bit elevated sales. And so yes, absolutely, that will be a very positive trend for us.

Operator

Our next question comes from the line of Michael Carrier with Bank of America Merrill Lynch.

Michael Roger Carrier - *BofA Merrill Lynch, Research Division - Director*

Just one another one, and this is more just on the modeling when you think about the outlook. When I think about the industry trends, mostly on the organic growth, obviously, it's been more of a headwind. You guys, from an asset mix, are relatively well positioned. But when you think about some of the things that you can offer to the Affiliates, are there other maybe big areas to focus on to maybe improve the scale or improve the efficiencies, but still maintain the independence of the investment teams and the investment strategies? Just wanted to hear your take, just given that the -- maybe the top line or the flow growth is different than it has been over the last, say, 20 years.

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Yes. So look, I think there is absolutely more we can do to bring the excellent, distinctive return streams managed by our Affiliates, that kind of diversity at scale without interfering with the culture that I was talking about before, there's absolutely more we can be doing. I'd say a lot more we can be doing, in partnership with them to bring those return streams to market. But I also don't think it's like a switch. I think this is an evolution that we've been on for more than a decade, like, 12 or 13 years now, kind of deliberately building out, paying attention to the pace of change, the level of investment, the returns we get on the investment, but deliberately building out the -- we've called them global distribution platforms, but it's institutional distribution platforms, it can be retail distribution platform. Again, we opened Japan, which, I think, we're very optimistic about. We opened it in partnership with one of Affiliates, Pantheon. Other Affiliates are going to be going to that market together with us. And each market is different. Each market has its own characteristics. And we need to be doing it in a way that -- again, in your question and what I said before, in a way that doesn't interfere with the thing that makes these firms special in the first place, which is their ability to produce these distinct return streams. Now we're having an ever-increasing pace of conversations with our Affiliates on how do they use the capacity of those return streams, how do they use the capacity of their investment processes. And at the same time, we're having more and more of those conversations with large pools of capital and large intermediaries. I kind of quickly referenced in an offhand way, we did enter into a memorandum of understanding, first one for us, with a distribution partner, a European financial institution. That would be a new extension. Now it'll start launching product, we believe, in 2019. But our operational teams and their operational teams are working on it. Our distribution people and their distribution people, both at the Affiliate level and at AMG, are working on making this really successful as a way for them to access the scale and diversity. And for some subset of our Affiliates and for some subset of their products, this could be a really exciting opportunity. But we're having lots and lots of those conversations. This just happens to be the first one that's gotten to this stage. But they also require us to do the work ahead of time in terms of selection and then we have to make sure we execute in an excellent fashion. So all of that goes to -- I think there's lots we can do back. On the efficiency side, look, I do think there are things that we can do there as well, and we have done some also for very long time. So for example, we have a very well-developed legal and compliance program, where we work -- we have, again, for more than a decade. I think we started it roughly around the same time we started building our global distribution platforms, in part, because we have to do a good job facing off with each of the regulatory regimes and all of these different places we're bringing our Affiliates to. And so we have been doing things like that. We've been doing things like joint purchasing in areas where it makes sense. But we do all of it with an eye towards how do we bring the benefits of scale to bear, but only where they don't interfere with the things that make our Affiliates so special, which is that diversity and autonomy and independence as part of the whole -- with AMG as a permanent institutional partner, so being able to bring all that scale to bear. And there's lots of things like that we do as well. But look, at the end of day, your question captures the challenge, which is, first, each of these firms does a great job bringing their products and services to some markets and some geographies and some channels in an excellent fashion themselves. And they're uneven, right? Some of will do more of that themselves, some will do less of it. And we've been building deliberately distribution platforms and others because this is a business about "How do we help them grow?" --distribution platforms to knit carefully to what they all do in a way that serves the range of Affiliates we have, the range of products and capabilities we have, and how we bring that to bear, again, very effectively for clients and intermediaries, the people who are going to use this. And that's where we have an increasing amount of our focus.

Operator

Our next question comes from the line of Alex Blostein with Goldman Sachs.

Alexander Blostein - *Goldman Sachs Group Inc., Research Division - Lead Capital Markets Analyst*

Just a quick follow-up on performance fees. Jay, can you remind us what percentage of AUM is subject to high water mark, kind of where that bucket stands today as we start thinking about next year? And then when it comes to the illiquids, understand the timing difference, but since you guys have been realizing quite a bit in the last couple of quarters, it also shows up in your AUM. When should we expect these strategies to contribute to performance fees?

Jay C. Horgen - *Affiliated Managers Group, Inc. - CFO & Treasurer*

Yes. So let me take the last one first. So we have been in a kind of an 18-month pretty significant fundraise cycle for us. And as you know, a number of our Affiliates, not all, but a number of them, we've partnered with in the last, say, 5 years. And when we made those partnerships, we had a lower share of the prior fund contribution. So when you look forward to that 18-month period, it usually takes 3, 4 in some cases 5 years, but 3 to 4 years to get through the investment period. At that time, you'll see additional performance fees come through that. I mean, I think, for now, it looks to be in that 2020 range, maybe before for some of the bespoke and more single strategy or single separate account-type mandate. Starting to see some next year, see it building into 2020 and, certainly, 2021. And it's going to be pretty significant, just given the fundraises that we have just gone through. And frankly, looking forward, we see that fundraising cycle continue. And we way undershot the amount and the duration of that, so we continue to see that very strong. Going to the performance fee question that you had asked, look, I gave you the -- sort of the qualitative answer. I think quantitatively, we don't think the right way to look at it is as some percentage of AUM. It really does depend on lots of different factors, including our share of that Affiliate, the sort of magnitude of outperformance in certain cases. So when we think about it, we bucket it by category. Earlier this year, the systematic sort of category was under high water mark, as I said that in my earlier remarks. That was really the only category that had that issue. That has changed. We are kind of at or around high water mark. And that's sort of the case in all categories. So we do see the potential for contribution, especially in '19, from all categories.

Operator

Ladies and gentlemen, that concludes our time allowed for questions. I'll turn the floor back to Mr. Dalton for any final comments.

Nathaniel Dalton - *Affiliated Managers Group, Inc. - President, CEO & Director*

Thank you again for joining us this morning. We were pleased with our results for the quarter and we are very confident in our ability to create long-term shareholder value. And with that, we look forward to speaking with you again in January. Thank you.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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