WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

BANKING BLUES

FIRST PUBLISHED NOVEMBER 2019

Whilst no industry is excluded from our analytical scrutiny, banks have seldom featured in our list of portfolio holdings. This should not be taken as a blanket loathing of these businesses. They are vital cogs in the functioning of an economy (albeit with the time-honoured ability to periodically throw a sizeable spanner in the works), yet for the stock-picker seeking sustainable long-term returns, the sector can be a fallow hunting ground.

ROY LECKIE
Investment Director

Every stock we consider is put through the rigorous mill of our bottom-up investment process to find financially strong, cash-generating businesses that we believe can deliver superior returns over an extended time horizon. In that regard, most banks currently fall short for a variety of reasons.

We invest in companies where balance sheet risk is minimal, preferring those that can generate high returns on un-geared capital. We are typically wary of the usage of leverage, and it is intrinsic in their business model that banks require an abundance of it to achieve satisfactory returns.

"There is a growing fear of 'Japanification' of the sector in Europe in particular"

All companies in varying degrees can be prone to the vagaries of economic cycles and management missteps. But such is the leverage versus equity inherent in banking, there are few industries where some drastic turn of the cycle or the irrational exuberance of a hubristic culture, taken to extremes, can lead to a wipe out of equity.

As a result, the history of the industry is pock-marked by periods where many of these vital economic organs have required the intensive care of the public purse and/or central bank largesse. The consequence of this has been increased regulatory intervention in the sector.

Tighter regulations have forced banks to hold more capital, and this is deemed to be *a good thing*. However, there are a number of banking executives who wonder if the animal spirits have been squeezed out of the sector. The reader might see this as also being *a good thing* given past transgressions. But reflecting on the banking industry in Europe, the CEO of Germany's Commerzbank recently bemoaned the triple whammy of tighter regulations*, a sluggish economy, and the margin-bashing impact of quantitative easing.

Banks relish economic growth; it is a driver of loan demand, and a rising interest rate environment helps them make money on the spread between their cost of capital and what they charge customers. That spread is currently paltry in many parts of the world. There is a growing fear of 'Japanification' of the sector in Europe in particular, in reference to the Japanese banking experience of years of potential profit growth hamstrung by super-low interest rates in a dull economic environment.

It is also true that in this extraordinary period of monetary laxity following the Global Financial Crisis (GFC), corporate debt has been rising. Sub-par businesses bloated with cheap debt, whose returns have been flattered by cheap money, will get their come-uppance should interest rates rise, or if demand for their product or service falters. Rising interest rates would benefit bank margins, but they might also herald an increase in non-performing loans.

"The complexity of the risk a bank assumes can be hard to understand"

The analysis of the sector might be a simpler matter if banks stuck to retail banking! It is not without its challenges in the shape of cyclical influences (and indeed various technology-focused upstarts are keen on disrupting this space) but it is a relatively straightforward business. However, the addition of various fee-generating and trading activities renders the forecasting of revenues a tough task.

The complexity of the risk a bank assumes can be hard to understand, as ably demonstrated by the GFC, where many senior executives failed to comprehend the consequences of the securitisation wheeze in which the rating agencies were so complicit. Such shortcomings are inevitably exposed at times of economic or market duress, but good times or bad, our view is that if management doesn't have a solid grasp of the risks inherent in a business, investors are not likely to have one either.

It is going too far to tar all banks with the same broad brush strokes however. The growth prospects of the developing-market banking sector contrast with the duller, developed-market financial environment. The opportunity presented by the provision of financial services to the unbanked masses is considerable, though cyclicality, excess bullishness, and government policy blunders have on occasion blighted their financial history.

That said, the harsh lesson dealt to bank executives during the 1997 Asian Financial Crisis (AFC) helped transform the recklessness manifest in many parts of Asian banking into a much more prudent business model. A number of banks in that region now sport some of the most robust balance sheets in the world in terms of capital adequacy. It is a pity, but not atypical of the culture, that many banks in the West did not learn from the AFC experience.

It's fair to say, however, that in the faster-growing emerging market (EM) banking sector, we've been wary of the lofty, 'priced-for-perfection' valuation multiples that some of the stocks command, given attendant EM risks.

"...we see little that might alter our fundamental reservations regarding the sector"

At present, we are retaining our cautious view on banks. Most good businesses across a range of sectors are

earning a return on invested capital which is a multiple of their weighted average cost of capital. This is generally less true of the banks; further lending weight to our argument that there are lean pickings in the sector.

Walter Scott portfolios are constructed with no reference to index weightings, and if there currently isn't a banking stock that satisfies our investment criteria, so be it. Should the dynamics change and we find a bank that we believe can deliver excellent risk-adjusted returns, then it would be considered a candidate for the portfolios.

The current lack of exposure to banks is not without relative performance risk however. Given the longstanding underperformance of the sector over the years, investor pursuit of perceived 'value' might induce a further rally which could present a risk to relative portfolio performance versus the benchmark. We highlight a 'further rally' because the US banking sector, (which is the largest component of the MSCI World Bank index), has recently seen a rebound in share prices, reflecting the respectable domestic economic backdrop.

In Europe, banking shares have shown signs of life, with the lure of optically cheap price-to-book multiples attracting investor attention, despite the low return-on-equity environment. We think there is a finite time limit to these trades. Even looking beyond the current signs of an ebbing economic tide, we see little that might alter our fundamental reservations regarding the sector. We will tolerate the short-term performance risk in the belief that the investment merits of the sector, from our long-term perspective, currently do not stack up relative to opportunities elsewhere.

*Financial Times; October 22, 2019.

IMPORTANT INFORMATION

STOCK EXAMPLES

WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM