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Banking blues II

This report was written by Walter Scott. As such, it is in its voice as opposed to that of BNY Mellon Investment Management.

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The collapse of Silicon Valley Bank has thrust the banking sector back into the headlines. Fifteen years on from the GFC, the industry is once again attracting the scrutiny of nervous regulators and investors. "Plus ça change" one might be tempted to say. At Walter Scott, we have long shied away from the sector, wary of its inherent leverage, opaque balance sheets, economic sensitivity, and penchant for periodic bouts of self-harm. And whilst it's true that the wider sector appears considerably more robust than it was back in 2008, we see no reason to alter that long-term view. Even in the near term, whilst the move away from the era of ultra-low interest rates has benefited the sector's net interest margins – a key indicator of profitability that measures the difference between the interest paid by a bank and the interest it receives – a more challenging economic backdrop may well usher in a period of rising corporate and consumer defaults. For now, we continue to identify myriad opportunities across a diverse range of sectors that offer superior growth prospects to the banking industry over the long term. In this article, first published in 2019 and updated in 2021, Walter Scott Executive Director Roy Leckie discusses in further detail why banks have been noticeable by their absence from our portfolios. The views and opinions expressed remain as relevant today as they were on publication.

Since the latter part of 2020, banking sector share prices across most major equity markets have awoken from their longstanding slumber. Driving the revival has been the prospect of economic recovery, their laggard 'value' status, and an expectation that after an extended period of extreme monetary largesse, the interest rate environment is set to take a favourable turn for the sector. Banks relish economic growth as it typically drives loan demand, while rising interest rates increase the spread between their cost of capital and what they charge borrowers, thus improving lending margins.

This spread has been miniscule in many parts of the world due to the bludgeoning effect of quantitative easing, as evidenced in economically moribund Europe. But even here, hopes have risen that the inexorable 'Japanification' of the sector, a reference to the Japanese banking experience of years of potential profit growth hamstrung by ultra-low interest rates in a dull economic environment, might be at least partially halted. In the US, the robust economic recovery and the prospect of an eventual Fed 'taper', have acted as powerful catalysts in improving investor sentiment. First-quarter results for the bulge-bracket banks saw trading and investment banking operations drive strong year-on-year profit expansion, although loan growth has hardly set the heather on fire. Compared to the financial industry centred maelstrom that was the GFC, banks went into the pandemic better capitalised and emerged with asset quality largely unimpaired. For the proponents of the sector, stronger economies and a more bank-friendly monetary environment are seen to be aligning to promote a cyclical upturn in the fortunes of these businesses.

> Banks, by the nature of their business models, require an abundance of leverage to produce returns

Banks remain noticeable by their absence from our portfolios. We have never argued that these businesses won't have their periodic moments in the sun, but we have not changed our opinion with regards to them being a fallow hunting ground for us as long-term investors. As we remarked in our original 'Banking Blues' report of November 2019, we have no blanket loathing of the sector, but we rarely come across any banks that meet our investment criteria. We invest in companies where balance sheet risk is minimal and quantifiable, preferring those that can generate high returns over the long term on un-geared capital. Banks, by the nature of their business models, require an abundance of leverage to produce returns. All companies to varying degrees can be prone to the vagaries of economic cycles, competitive threats, execution risks and management missteps. But such is the balance of leverage versus equity inherent in banks, there are few industries where some cyclical cataclysm or the irrational exuberance of a hubristic, risk-taking culture can lead to such destruction of equity.

Given the sector's unfortunate habit of requiring the occasional bail out from the public coffers or assistance from obliging central banks, the regulatory environment has, understandably, become more rigorous. Being required to hold more capital, for one, is an inevitable consequence of past transgressions. Plenty of banking sector CEOs, particularly in Europe, have bemoaned the impact of tougher regulations, which have added to the earnings-dampening straightjacket imposed by lacklustre economies and the QE-induced suppression of interest rates. An infusion of growth may well improve matters, as will non-performing loan provision reductions and writebacks in the wake of the sector's resilience through the pandemic.

> Structural challenges are mounting

However, the pandemic was remarkable for the scale of government intervention, with fiscal budgets bearing the brunt of bailouts and furloughs, thus alleviating the pressure on the banking sector. We have been through an extraordinary period of monetary stimuli since the GFC, and corporate debt has been rising. There are plenty of sub-par businesses, bloated with debt, whose returns and financial health have been propped up by cheap financing. More-expensive money and the drawing to a close of support measures may pose a threat to these businesses, dampening the otherwise improving non-performing loan picture and diluting the beneficial impact of rising interest rates and stronger economies.

Structural challenges are mounting. The topic of cryptocurrencies was the subject of a recent research session we had with an economist from the University of Edinburgh. Whilst we would pour scorn on the current cryptocurrency craze, many central banks, fearful of the loss of monetary control they engender, and their usage for illicit purposes and rampant speculation, are mulling over, albeit to varying degrees, the issuance of their own digital currencies. The Bahamas launched the 'Sand dollar' in 2020, and China is currently trialling an 'e-yuan' while ramping up its campaign against private cryptocurrency operators and speculators. A central bank digital currency is the equivalent of having a deposit with the central bank. This raises the prospect of deposits being pulled out of the banking system, particularly at times of crisis, and into the 'safer hands' of a central bank's balance-sheet, consequently resulting in an undesirable disintermediation of the banks.

Alternative financial banking models are increasing in scale and importance. From crowdfunding to nimble fintech companies to Big Tech with its oceans of customer data; enabled by technology, banking industry competitive dynamics are changing. An OECD report* of last year opined that "there is no doubt that the short-run impact of the digital disruption will be to erode the margins of incumbents and increase the contestability of banking markets". Fintech-backed financial products can offer a better user experience with operators enjoying deeper data sets than traditional banks, and hence they can reach customers underserved by traditional banking.

> Banks benefit from the virtues of incumbency, but the ever-evolving competition is snapping at their heels

This has been the case in China, where Ant Group accumulated around 1.3 billion payment users, a majority market share in third-party mobile payments, and a significant portion of the online consumer credit and wealth management markets… until the regulators stepped in. Wary of the company's growing financial power, its accumulation of personal data, and miffed at founder Jack Ma's outspokenness about China's regulators, the authorities are reining in its activities. Across the globe, regulators are striving to get up to speed with the impact of the rapidly evolving fintech scene, mindful of the need to protect the consumer and the financial system. But banks are seeing the competitive threat and investing in technology, with some collaborating with fintech partners. The banking industry is being obliged to update its technological platforms and move further into the cloud, as well as reduce branch overcapacity and offer a standard of service that competes with the encroaching new entrants. Banks benefit from the virtues of incumbency, but the ever-evolving competition is snapping at their heels.

Notwithstanding this, at least a basic retail banking model is a relatively straightforward business and easy to understand. However, the addition of a variety of fee-generating and trading activities makes forecasting revenues difficult, while adding on a complexity of risk that is difficult to weigh. As demonstrated by Credit Suisse's debacle regarding its prime broking client Archegos, banks sometimes fail to comprehend the risks inherent in their own business. No company offers perfect visibility, but opacity abounds in the banking sector. How can investors model for an 'out-of-the-blue' implosion of an obscure hedge fund? If management doesn't have a solid grasp of the risks inherent in a business, investors are not likely to have much of a clue either.

One might look more benignly on the banking sector within developing, rapidly growing parts of the world, where the provision of financial services to the increasingly affluent and relatively unbanked masses represents a considerable growth opportunity. Cyclicality, excess bullishness, and government policy blunders have on occasion blighted their financial history, although in Asia, the harsh lesson dealt to bank executives during the 1997 Asian Financial Crisis helped transform the recklessness manifest in many parts of Asian banking into a much more prudent business model. It's fair to say, however, that in the fast-growing emerging market (EM) banking sector, we've been wary of the lofty, 'priced-for-perfection' valuation multiples that some of the stocks command as well as some of the attendant EM risks.

> We see little that might alter our fundamental reservations regarding the sector

Walter Scott portfolios are constructed without reference to index weightings or benchmarks. Our sole aim is to find stocks that meet our rigorous investment criteria and that can produce sustainable earnings growth over our lengthy holding periods. Should we find a bank that we believe can meet these criteria and deliver excellent risk-adjusted returns, then it would be considered a candidate for the portfolios, but at present we see little that might alter our fundamental reservations regarding the sector.

We accept that the current lack of exposure to banks is not without relative performance risk, and markets have indeed been celebrating a cyclical upturn to the extent that the apparent 'cheapness' has now evaporated in some cases. But we are not governed by the fear of missing out. There are plenty of opportunities in companies in diverse sectors that offer superior growth prospects over the long term without the operational and financial risk baggage that accompanies the banking sector.

* OECD February 2020: Digital Disruption in Banking and its Impact on Competition.

The value of investments can fall. Investors may not get back the amount invested.

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