Why Banks are Undervalued

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by Robert Huebscher

David Ellison manages the Hennessy Large Cap Financial Fund - HLFNXand the Small Cap Financial Fund – HSFNX. As of 11/30/19, since their inception on 1/3/97, HLFNX has outperformed the Russell 1000® Financial Services Index by 75 basis points annually, and HSFNX has outperformed the Russell 2000® Financial Services Index by 125 basis points annually. Ellison has over three decades of investment management experience and has been recognized by Morningstar as the most tenured mutual fund portfolio manager in the financial services sector.

Prior to joining Hennessy Funds in 2012, Dave served as president and chief investment officer of the FBR Funds, where he launched and oversaw the line-up of FBR Funds. David began his career at Fidelity, where he managed the Select Home Finance Fund, and he developed his investing discipline and strategy under the tutelage of famed value investor, Peter Lynch.

Dave received a BA in Economics from St. Lawrence University and an MBA from Rochester Institute of Technology.

I spoke with Dave on December 12.

What are the mandates of the Hennessy Small Cap and Large Cap Financial Funds, and what are your general guidelines for buying and selling securities and constructing the portfolios?

These are both financial sector funds. They have to be 80% invested in the sector. The market cap breakpoint is $3 billion between the two funds. They can invest in any financial companies.

We don't try to do too much buying and selling. We hold for the long term. We're looking for companies that can grow book value and capital over a period of time, those that are paying attention to all the things that you would hope they'd pay attention to, like costs, credit, and liquidity. The well-run companies tend to stay well-run and the poorly run company stay poorly run. That tends to make for low turnover in the portfolio. The small-cap fund is comprised primarily of traditional banks as opposed to other types of companies.

The smaller you get, the more important it is to have a stable liability structure, and an insured-deposit structure gives them the ability to generate liquidity, the same as with Citibank or Bank of America. You don't see that in other non-depository institutions. Our large-cap fund is more of a mix. In the last four or five years, it's gotten less bank-like and more transactional or “fintech.” That's the nature of how the industry is progressing.

Given your focus on banks in both funds, how strong are the fundamentals in the banking industry?

Fundamentals generally are at the high end of their historical range. Non-performing loans are at the low end of the range. Capital ratios are the high end of the range, historically. Lending margins are about in the middle, even though rates are much lower than they were a couple of years ago. I've been doing this since the early 1980s, and the way I perceive the world is in that timeframe. I believe the industry is in great shape. The regulatory structures that were put in place post-2008 have created a much more stable system. That's helped generate or create the recovery that we've had since 2008, and it's sustaining the growth in the economy that we have now.

What is the relationship between interest rates and profitability among banks? Since you mentioned the fact that rates are historically low, given the fear that many have, how would rising rates affect banks?

If you look at smaller banks, the smaller you get, the more important the lending margin is, or the spread between the cost of funds and the yield on assets. For a typical smaller bank, the net interest that they earn off their portfolio could be 80% to a 100% of their revenues. Obviously, the direction of rates and the nature of the yield curve is very important. For larger banks, Citicorp, JP Morgan, and the like, the spread accounts for around 50% of their revenue. . Rates are obviously very important. It's not just the rate at one point, but it's a rate across the whole curve.

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There's been some talk lately about the yield curve inverting, but it's not inverted for the banks. The Treasury curve may invert, but the bank curve is not inverted. The prime rate is still well above the cost of funds. Interest rates have become a big issue primarily because they've come down so much. They're low and close to zero. If rates were 100 basis points, then 25 basis points is low. I started when Fed funds were 18%, and now they're effectively 1% or 2%. They're so close to zero that the presumption is that your cost of funds isn't going to go below zero. It starts to hurt spreads. The big boogeyman in the industry now, the thing that's keeping the companies from attaining an above average valuation on book and earnings, is the prospect of rates going lower and squeezing that margin. You've seen what's happened in Europe. The European banks trade at about half the valuation of the U.S. banks for that reason.

You mentioned the fact that the banks are at the mercy of their own yield curve, not necessarily the Treasury yield curve. Is there a point where the bank's yield curve inverts to the degree that it would threaten them?

It has in Europe and it has to some degree in Japan. Yes, it would. The central banks of the world are starting to realize that lowering rates below zero is not a good thing for the banking industry – for liquidity and the lending structure that we have. There is a realization that negative rates don't help. The best thing they could do in Europe is get rates slightly above zero and allow the banks to get some relief with a bank yield curve that will allow them to make money and start lending again.

There's also a difference between Europe and Japan, in terms of having negative rates versus the reserve currency having negative rates. Part of the problem with the Fed and the current repo situation is the fact that there are so many negative yielding securities around the world. There isn't enough ample collateral with a positive yield to be used and borrowed against.

Do you fear that the U.S. would ever adopt a policy that would mean negative nominal rates?

Mathematically it doesn't make sense. It doesn't mean they won't do it. Coming back to the valuations, the attractiveness and the interest in this space, the market is not expecting negative rates in the U.S. People are worried that the Fed will go to negative rates and that will have a detrimental impact on margins. When the bulk of the industry gets the bulk of its profit and revenue from the margin, that's a negative. The Fed needs to talk everybody off the ledge and convince them that they're not going to implement a negative-rate policy. That that would be a tightening and not loosening policy.

You spoke earlier about the fact that many of the operating metrics related to banks are favorable relative to their historical averages. How do the valuations of banks compare to their historical averages?

They're at the low end, one standard deviation below the average. But they're not super cheap, relatively. They certainly are cheaper than they have been historically. Price-to-book and P/E are the two metrics to look at. Investors are afraid of the coming recession that doesn't seem to come, and they're afraid of negative rates. We have 2008-2009 hanging over the industry from a credit perspective. People assume that's going to happen again and we're going to have another Bear Stearns and financial stocks are all going to zero again.

We also have the fact that the European and Japanese central banks have gone to negative rates. Banks have been harmed, and they trade at half their price-to-book and earnings as they do here. That's what's keeping the group from having a fair valuation that would be more in keeping with their current profitability metrics.

For the large-cap fund, you mentioned earlier that you look at many non-bank companies, particularly in the fintech sector. What are the opportunities that you're seeing?

The opportunities are to “keep it simple.” It's the computerization of the industry, and it's the cell phone utilization and infiltration into the industry. People are going mobile and don't necessarily want to use bank branches. The customer base is becoming younger. People who like donuts and the coffee on Saturdays are dwindling, and those who use their phones and don't want to deal with the physical bank are growing. That transition is happening, and the opportunities are to build a business that doesn't require as much of a balance sheet. That's the big transition in this industry that will go on for many years.

If you go back to the 1970s, through the 1980s, 1990s, and the early 2000s, rates were coming down. We had a 30- to 35-year bull market in bonds, and the industry built up a tremendous balance sheet. Asset prices were rising because the Fed was lowering rates and investors assumed they would solve all the problems.

Now you have massive balance sheets built up during that decline in rates, and that presumably is behind us. I don't see that we're going to have another 30-year bull market in bonds. We need to reorganize these companies to have fee structures that are not balance-sheet heavy, because the balance sheet is going to earn less and less over time and be

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less and less valuable. You see the market making that choice. VISA and MasterCard are trading at 30-times earnings, and JP Morgan and Bank of America are trading at 12- or 11-times earnings. The market is telling you what it wants. It is telling you where it views the value in this industry. That's where the industry is moving. The bigger companies are doing it faster because they have more resources. The big shift in the industry is to move toward balance-sheet light businesses, and those companies will continue and be a big part of what I do in the large-cap portfolio.

Let's turn to the small-cap portfolio. What are the potential drivers for the banks that you tend to hold in that fund?

Those are traditional banks in local communities. They don't have a big market presence. Our goal is to look for good managers who understand that they're not going to reinvent the wheel in the industry. They're not going to be the fintech leader. They're not going to turn into something super special. They've got to operate within their market, service their clients, deal with expenses, deal with credit trends, and compound returns and book value over time

Once you have that, then you have what we call in the industry a “currency,” where your stock is trading at a valuation that allows you to consolidate the markets around you in an accretive manner. You can buy your neighbor. Your stock is trading at a valuation that's attractive relative to his, because he hasn't done as well. You can consolidate concentrically around your core franchise and create value. You can take a $2 billion bank and turn it into a $20 billion bank through a series of acquisitions. If they're done appropriately, the stock should reflect the accretive nature of those acquisitions.

You mentioned earlier the specter of a recession. Do banks have adequate liquidity and low enough leverage to weather that eventuality?

It would appear that's the case. I'm going to ramble here a little bit because it puts it in context. The regulatory structure going into 2008 was set up for an accounting convention that was higher of cost or market, and not mark-to-market. When I started in the business, the accounting convention was higher of cost or market for assets. If rates went up or down, they didn't have to reprice their assets; they could just leave them at the higher of those two. When rates fell, everybody wanted mark-to-market, because it would benefit them. In 2008, you had a situation where mark-to-market, not rates, kicked off a credit crisis. The accounting and regulatory structure was not built for that.

They didn't have enough liquidity or reserves. Mark-to-market kicked in, and we had real problems because even though banks hadn't sold anything, their assets were marked down; they were technically insolvent. That's been corrected. We have a system where the banks have ample liquidity to deal with a rise in rates or credit costs, which people are underestimating. That gets back to this regulatory and structural transition that we've made within the industry.

It's a long winded answer, but the regulatory structure that's been put in place gives banks ample liquidity and gives the regulators ample power to, in a sense, create or force them to have that liquidity.

What are the key long-term secular trends that will affect banks in the financial sector? You spoke earlier about fintech. Where do you see the greatest opportunities for technology disruption?

The industry is going to become more asset-light. There's been not only a tremendous amount of assets built up in the industry, but there's also been a tremendous amount of cost and structure that needs to be broken down. I look at the banking industry as the auto industry in the 1970s. The Japanese showed up, the U.S. was under investing and was too structured. It took the auto industry in this country to fail twice to get competitive again.

We had the financial system fail in 2008, but that wasn't because of anybody else; it was because of us. The banking industry is now converging around a much different structure and it will generate higher and more stable returns.

This new structure will lead to massive consolidation around asset light, credit adverse, fee based, mobile capable, low cost, highly liquid franchises.

With what Schwab is doing by acquiring TD Ameritrade, or even among the smaller-cap banks, there's been a lot of consolidation to get scale. There's a lot of opportunity to cut costs, generate revenues that are asset-light, computerize the lending and deposit structure through the cell phone and other mobile applications that everybody wants. That will drive customers and if banks can do it profitably, the returns on equity should stay high and hopefully the stocks will reflect that transition.

But the big fear today is a repeat of the 2008 recession and the fact that rates in this country could go negative. You have two big boogeymen that you need to overcome. But in the meantime, these companies continue to move forward and get better.

How do you distinguish your funds from their competition and particularly from an ETF that might simply follow a financial-sector index?

I don't spend any time at all looking at the performance of the funds relative to indexes. The large-cap fund has 24 names in it. The small-cap fund has 32 names in it. They are what I believe to be the best names within the space. In small-caps, there are about 500 or 600 of candidates. On a quarterly basis, we're choosing 30 to 40 names. In large-cap, there aren't as many, but I'm buying the names that we think are competitive in the long term, and not worrying that much about the current valuation relative to where it's been two or three months ago. I don't worry about what CNBC thinks.

I believe the companies we own are in the right place at the right time. Longer term they should outperform and that reduces your turnover and your capital gains. I'm saying to myself, “Look, the industry is moving in this direction, I'm going to own those 30 or 40 names that I believe are best positioned to do that and not get too caught up in the day-to-day stuff like the Fed meetings and whatever else.

What is the one risk that keeps you up at night?

The biggest thing for me is if the Fed, for some reason, does something that creates a downturn that forces them, or politically puts them in a box, to have to lower rates enough to create a negative-rate scenario. The banks can deal with credit, they can deal with regulatory, they can deal with cost cutting, and they can deal with commission cuts. But they can't deal with very low rates. There's nothing they can do about it. If mortgage rates go to 1% we could resemble Japan, where it is 75 basis points for a mortgage, the banks trade at 30% of book, and there's very little earnings. If that happens here, bank earnings will decline quite a lot.

The hope is that we'll have an economy that will allow the Fed to keep rates where they are now. Even though everybody says they're low, it's not a problem for the banks; they're amply profitable. Their margins are amply high. Their ability to generate low-cost deposits is fine. But if you take rates to zero and put them into negative territory, there's nothing they can do. Making loans at 1% is just not a profitable option.

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