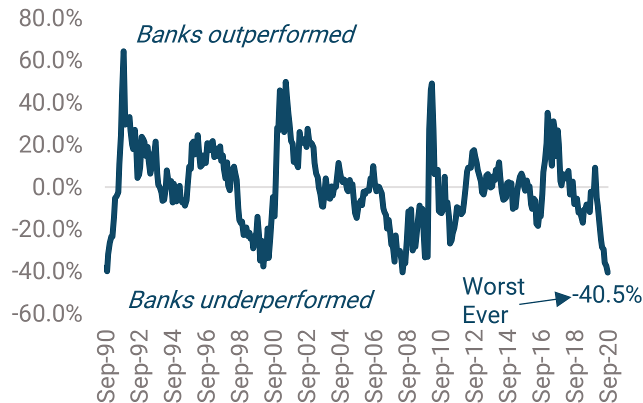
BANKS: INVESTING IN AN UNLOVED INDUSTRY

We view the banking industry as among the most attractive segments of today's equity market. We see tremendous potential upside given the depressed valuations, while the primary risks are either manageable, misunderstood, or both. It is an industry that provides an essential service to individuals and businesses alike, with little to no obsolescence risk. The most frequent and provocative counterarguments we observe from bank cynics are: 1) low interest rates are here to stay, which will hurt future earnings, and 2) COVID-related credit losses will impair balance sheets and/or reduce future earnings. This paper will highlight banks' rare valuation opportunity and then address these skeptics' concerns, which is why we believe the valuation opportunity exists in the first place.

A RARE VALUATION OPPORTUNITY

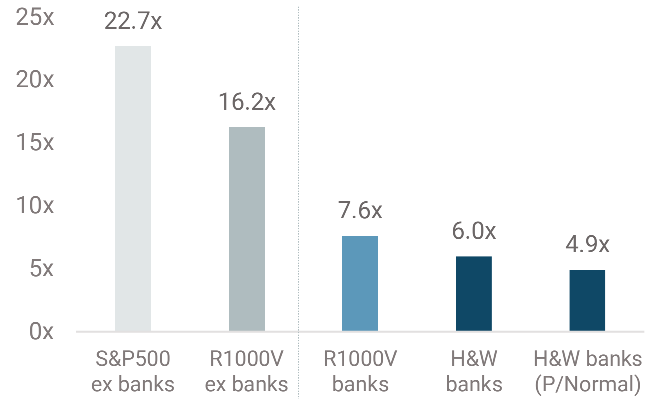
As shown in Chart 1, banks have underperformed the broad market by the widest margin in at least 30 years. This includes both the savings & loan crisis of the early 1990s and the financial crisis of 2007/08.

Chart 1: Banks vs. S&P 500, Trailing 12M Performance
As of September 2020



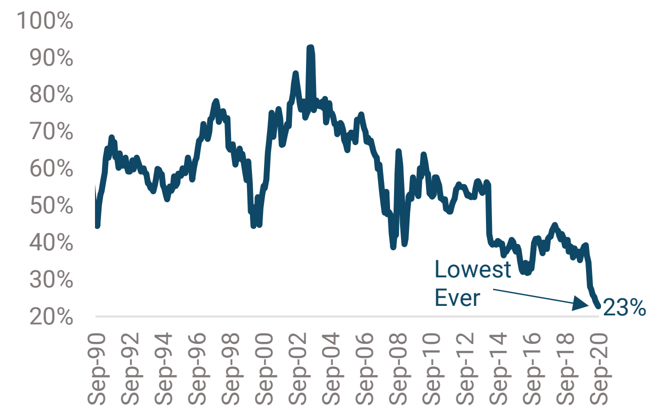
The underperformance has resulted in a valuation discount for banks that we find striking, as shown in Chart 2.

Chart 2: Price/Trail Earnings (2019 Earnings)[1]
As of September 2020



Banks typically trade at a modest discount to the market, but today's discount is the largest on record (see Chart 3).

Chart 3: Banks P/B as a % of the S&P 500 P/B
As of September 2020



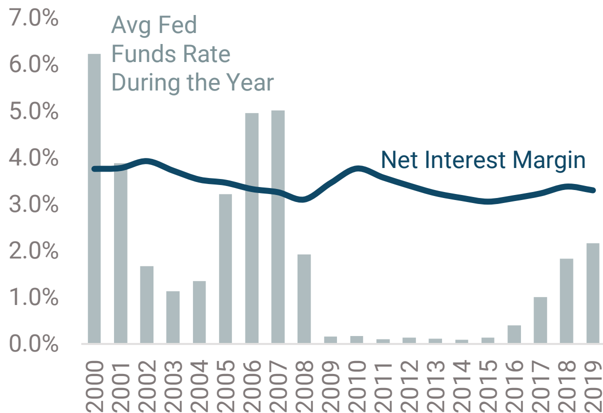
As mentioned, the primary reasons behind the massive valuation opportunity appear to be the low interest rate environment and concerns about COVID-related credit losses. We will address these issues in the next two sections, respectively.

[1]H&W banks defined as all banks held in the Large Cap Fundamental Value strategy

LOW INTEREST RATES

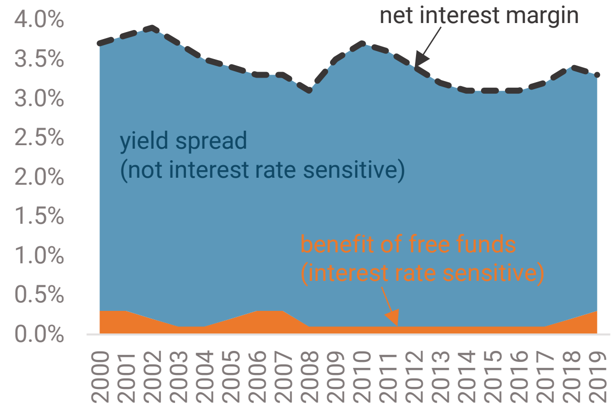
Net interest margin, “NIM” hereafter, is a closely followed banking industry metric to gauge profitability. Oversimplified, it is the difference between the interest a bank earns and the interest a bank pays, as a percentage of its earning assets. Conventional thinking is that banks’ NIM increases as interest rates rise and decreases as rates decline. The logic being interest paid by a bank is relatively static, but interest earned by a bank is not. For example, the interest a bank pays on a savings account changes very little as interest rates change, but the rate it earns by investing in short-term notes or by making loans can change significantly. When rates rise, therefore, banks might pay a little more interest, but they will earn a lot more interest, and vise-versa. Empirically, however, interest rate changes have had very little, sometimes even counterintuitive effects on net interest margins, as depicted in Chart 4. Over the last 20 years, the Fed Funds rate has ranged from 0% to 6% but banks’ net interest margins have been remarkably stable.

Chart 4: Net Interest Margin and the Fed Funds Rate
All FDIC Banks
As of December 2019



Banks’ net interest margins are dictated by two factors that we refer to as: 1) the yield spread, and 2) the benefit of free funds. Of the two, the yield spread is the more important driver by far, averaging more than 90% of the NIM over the past 20 years (see Chart 5).

Chart 5: Net Interest Margin & Its Components
All FDIC Banks
As of December 2019

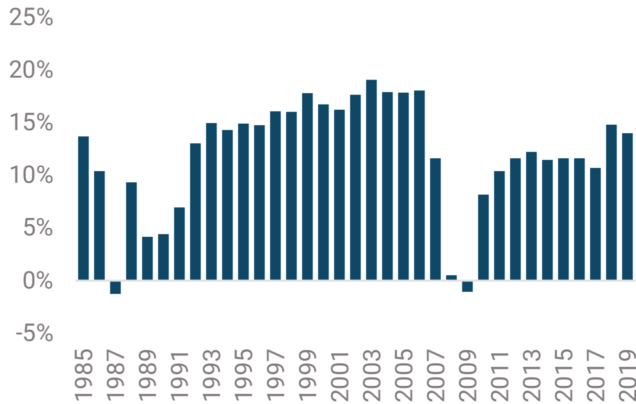


The yield spread is not interest rate sensitive, or at least has very low sensitivity to interest rates. It represents the difference between what a bank receives on earning assets and the rate it pays on interest bearing liabilities. Because loans comprise about three-quarters of earning assets, the margin over short-term benchmarks that banks earn on their loan books is the primary driver of yield spread. The yield spread is not just insensitive to interest rates, it can sometimes exhibit countercyclical traits. When rates decrease, for example, businesses and/or consumers may have increased incentive to borrow. This can increase loans as a percentage of earning assets. Further, banks often tighten lending standards as non-bank competitors retreat.

The benefit of free funds is self-defined. It is the benefit banks get from funding part of their earning assets with non-interest-bearing sources, like deposits. As rates move toward zero this benefit dissipates, but again, this typically comprises a small fraction of a bank’s NIM.

The ultimate effect of persistently low interest rates on bank profitability is likely negative but only marginally so. Even if banks’ benefit of free funds disappears entirely, they should still be able to generate a net interest margin that would result in better cost of capital returns. Further, many banks—particularly the large money centers—also have business lines beyond traditional banking (e.g. investment banking, asset management), which further reduces the companies’ interest rate sensitivity.

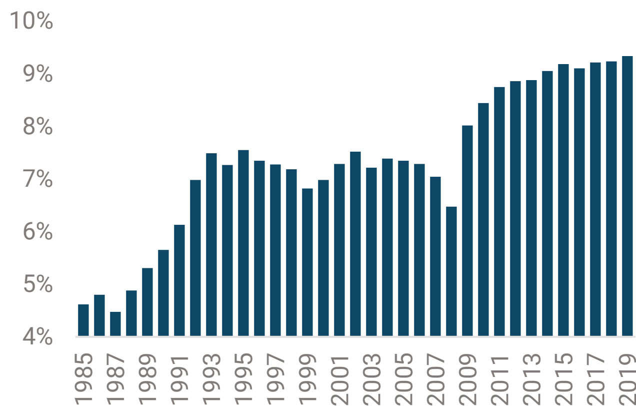
Chart 6: Return on Tangible Equity
All FDIC Banks
As of December 2019



COVID RELATED CREDIT LOSSES

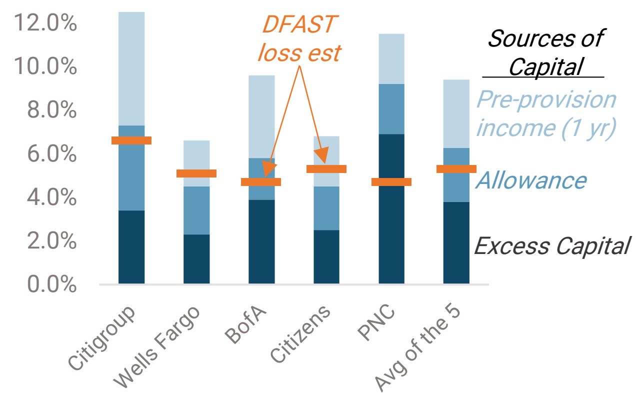
Balance sheets throughout the banking industry have improved over the last 30 years, particularly since the financial crisis of 2008/2009. Chart 7 shows one popular measure of balance sheet strength—tangible common equity to tangible assets—which recently reached its highest level in at least 30 years.

Chart 7: Tangible Common Equity / Tangible Assets
All FDIC Banks
As of December 2019



The Dodd-Frank Act Stress Test ("DFAST") is an annual review conducted by the Federal Reserve. It is designed to ensure that all major US banks can withstand a severely adverse economic scenario. Among the most notable assumptions in this harsh hypothetical environment are a cumulative real GDP decline of more than 8.5%, unemployment of 10%, an equity market decline of 50%, and a housing market decline of 28%. The orange lines in Chart 8 represent the estimated level of loan losses, as a percentage of total loans, under this extreme scenario for select banks. The blue bars represent three different sources of capital that could be used to absorb these hypothetical losses. *Excess capital* represents the amount of capital held by the banks above the regulatory requirement. *Allowance* represents the amount of additional capital the bank has set aside, earmarked specifically for credit losses. *Pre-provision income* represents the amount of capital the bank generates through ongoing operations.

Chart 8: Capacity to Withstand Elevated Credit Losses as a % of Loans (H&W banks[2])
As of June 2020



Each bank from Chart 8 has sufficient capital to absorb losses under an extremely adverse scenario, while still maintaining capital ratios above regulatory requirements. If a bank did not have sufficient capacity to absorb losses through the combination of excess capital, loan loss allowance, and pre-provision income, it would need to raise equity capital to comply with regulatory requirements. Equity raises dilute shareholders, which appears to be a concern in the market. We believe the opposite is more likely. Credit losses could be lower than what banks provisioned for during the first half of 2020. Accounting rules require banks to estimate loan losses upfront based on prevailing economic conditions. The provisions taken over the first half of 2020, when uncertainty surrounding the pandemic peaked, may prove to be overly conservative.

[2]H&W banks defined as all banks held in the Large Cap Fundamental Value strategy as of the publication date, but may be sold and no longer held in the strategy at any time, for any reason, without notice, subsequent to the publication date. The securities reflected herein are intended to be for illustrative purposes only and are not intended to be, and should not be construed as, investment recommendations or investment advice. Past performance of these securities, or any other investments, is not an indicator of future results. Hotchkis & Wiley's opinions regarding these securities are subject to change at any time, for any reason, without notice.

POTENTIAL CATALYST

Increased visibility into the credit loss environment should serve as a catalyst for banks. For H&W banks, the amount of excess capital above internal management targets represents 10% of the banks' total market cap. The amount of excess capital above regulatory requirements (which are less stringent than internal targets), represents 25% of the banks' total market cap. If it turns out that banks' provisioning/allowance build during the first half of 2020 was overdone, these companies will have even more excess capital on their balance sheets. This is capital that should eventually be returned to shareholders via dividends and share repurchases. The current dividend yield for H&W banks is 3.7%. If dividends resume to pre-COVID levels, the dividend yield for this group would exceed 5%. This compares to the current dividend yield of the S&P 500 at 1.8% and the Russell 1000 Value at 2.6%. Further, share repurchases are highly accretive to earnings and book value per share when done at attractive valuations—H&W banks trade at less than two-thirds of book value as a group.

CONCLUSION

We currently view banks as among the most attractive risk/reward opportunities in the equity market. Many banks trade at a discount to book value, low multiples of recent earnings, and extremely low multiples of normal earnings. The reason banks exhibit such attractive upside is due to concerns about persistently low interest rates and pandemic related credit losses. We believe the interest rate concern is misguided and the credit loss concern as manageable. Banks have never been as well-capitalized, i.e. prepared for a challenging environment, as they are today. As this becomes evident and substantial excess capital is returned to shareholders, we believe the market will recognize that these stocks are significantly undervalued.

Data sources: Charts 1 & 3: S&P, Bloomberg; Chart 2: Bloomberg; Chart 4: FDIC, Bloomberg; Charts 5-7: FDIC; Chart 8: FDIC, Bloomberg, Company Reports.

"H&W banks" are defined as all banks (based on GICS industry classification) held in the Large Cap Fundamental Value (LCFV) Strategy. Banks held in other equity strategies of the firm may not be reflective of the banks highlighted and subject to other economic scenario stress tests and/or regulatory requirements under different federal, state or international jurisdictions. No assurance is made that all banks held in the firm's equity strategies were or will be profitable. H&W has no obligation to disclose purchases or sales of the banks highlighted. In addition, the securities identified do not represent all of the securities purchased, sold, or recommended for advisory clients, and may not be indicative of current or future holdings or trading activity. H&W provides no assurance that all investment decisions were or will be profitable. Portfolio holdings are subject to change without notice; a complete list of holdings is available upon request at hotchkisandwiley@hwcm.com, subject to the firm's portfolio holdings disclosure policy.

Certain annual historical data presented in the charts may not be indicative of current year to-date results through September 30, 2020. Actual results in 2020 could be materially different from the historical information presented. The opinions of the authors are subject to change with new and updated information without notice.

Market Disruption: The recent global coronavirus pandemic has caused and continues to cause disruption in the global economy, unprecedented business and travel disruption and extreme fluctuations in global capital and financial markets. H&W is unable to predict the consequences of the upheaval caused by coronavirus pandemic, which, depending on the severity and the length of the outbreak, has the potential to negatively impact the firm's investment strategies and reduce available investment opportunities.

All investments contain risk and may lose value. Equity securities may have greater risks and price volatility than U.S. Treasuries and bonds, where the price of these securities may decline due to various company, industry and market factors. Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods. Investing in smaller, medium-sized and/or newer companies involves greater risks not associated with investing in large company stocks, such as business risk, significant stock price fluctuations and illiquidity.

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