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Podcast Transcript

U.S. Financials

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Scot Hoffman: Welcome to Dodge & Cox Investment Perspectives, where we take a close look at key themes in our investment portfolios in conversations with our Global Industry Analysts. I'm Scot Hoffman in Communications. Today we're talking about U.S. Financials, an area of the market that has reflected significant pessimism over the last year but one in which Dodge & Cox sees very attractive long-term investment opportunities. The Dodge & Cox Worldwide Funds U.S. Stock Fund and Global Stock Fund have significant exposure to U.S. Financials, even despite low interest rates in the U.S. This exposure is diversified and includes holdings in the Banks, Capital Markets, Consumer Finance, and Insurance industries. I'm joined by Phil Barret and Keiko Horkan. Phil is a member of our U.S. Equity Investment Committee, the head of our Financials Sector Committee, and a Global Industry Analyst covering brokers, banks, asset managers, and exchanges. Keiko Horkan is a Global Industry Analyst who covers banks, specialty, and consumer finance, and also sits on one of our Equity Investment Committees. Welcome, Keiko and Phil.

Phil Barret: Thanks Scot.

Keiko Horkan: Thank you for having us.

Scot Hoffman: Let's start with you, Phil. For U.S. Financials, how would you characterise this current market environment versus another period of crisis we saw, the global financial crisis, a decade ago?

Phil Barret: Well Scot, the COVID-19 crisis is a very different crisis from the global financial crisis. Fundamentally, the pandemic is a health crisis that's led to a sudden stop in global economic activity. We've never experienced anything like it before. Policy response has been rapid and significant, and the impact on banks has been very different from the global financial crisis. The banks entered the COVID crisis in much stronger shape. Banks have broadly remained profitable, built capital levels, and serviced the real economy through the downturn. Again, the epicenter of the crisis is a health problem, and we're optimistic that with the approval and rollout of vaccines, normal economic activity can resume relatively quickly. By contrast, in the global financial crisis the consequences of excessive debt and poor balance sheets took many years to resolve.

Scot Hoffman: Keiko, what would you add?

Keiko Horkan: I would also add that consumers are in quite a different position compared with the global financial crisis and banks' underwriting has been tighter as well. As a result, consumer credit is performing exceptionally well at the moment. Now first of all, consumers entered this pandemic in good financial shape, and then we've had the Cares Act. Three-quarters of the unemployed were making more than they did when they had a job, and the savings rates are higher than pre-pandemic levels. And third, the industry and the government were quick to put in place broad deferral programs as you would see after natural disasters. And finally, asset prices—home prices, equity markets, the used car prices—all have been very strong.

Scot Hoffman: Now that we're seeing a second wave of the pandemic here in the U.S., what do we see as the impacts on fundamentals for U.S. Financials, Phil?

Phil Barret: Well Scot, I think the first order impacts of the COVID-19 crisis have been broadly negative for the banks in two major ways. First, banks have experienced lower net interest margins due to lower interest rates. Banks are currently gathering deposits near the zero interest rate boundary and then reinvesting them at lower policy rates leading to margin compression. The second negative factor has been on credit costs. Banks have front-loaded loan loss provisions through the course of 2020 based on expected credit loss accounting. As a result, banks are broadly reserved for higher unemployment levels than current levels. So unless the economic outlook deteriorates, no further provision build is expected and indeed, reserve releases are possible in 2021. Having said that, there have been some positive revenue offsets in the COVID crisis as well. Capital markets trading, wealth management, and mortgage banking revenues have been robust through the downturn. But I think, again, the story for banks is resilience in the face of a historic economic shock, which has validated a lot of the post-global financial crisis regulatory changes.

Scot Hoffman: The Federal Reserve has emphasised a commitment to substantial monetary accommodation and has pushed to keep interest rates near zero for an extended period of time. Since we look at companies on a bottom-up basis, why do you believe U.S. Financials are currently in a position of strength?

Phil Barret: Well Scot, we see a very compelling setup for long-term investors in U.S. bank stocks today. I think the first key point is bank earnings are bottoming out. As we mentioned, banks front-loaded loan loss provisions in 2020 to levels that now appear conservative, and adding to that, low interest rates should be a diminishing headwind through 2021 unless the yield curve were to flatten from here. In contrast, it's recently steepened. Secondly, capital returns should significantly increase. The Federal Reserve has temporarily restricted capital return by financials in response to the crisis. Since that restriction was put on, banks have been building excess capital. When the restrictions are lifted, banks should be able to deliver very high total yields, supported both by earnings generation and returning excess capital. Thirdly, bank P/E valuations are near historical lows relative to the market. Many financials are trading at single-digit P/E ratios compared to the broader market Index trading over twenty times. This discount is wide versus history and supports the value case for bank stocks. Indeed, multiple re-rating we think could support future shareholder returns. Finally, with a vaccine—I think this is quite important—a lot could change for the better in the coming year in the operating environment in ways that are hard to forecast. Unlocking of economies could lead to robust recovery and consumer demand in corporate investment. The yield curve could steepen. These factors would be very positive for banks in their operating environment. So you put all these things together and what do you get? Trough earnings, trough capital return, trough P/E multiple, and trough economic conditions. A lot could change for the better in the coming year.

Keiko Horkan: As Phil mentioned, banks are carrying a significant amount of capital, partly due to the lack of growth in risk assets as well as the regulatory path on capital return to shareholders. This fixed-risk capital is worth 15% to 40% of market capitalisation of equity at the major banks, and even on this strong capital base, I wanted to emphasise the banks were able to generate a return on tangible common equity of 12% in the third quarter, which isn't too far from pre-pandemic levels. So the banks are in great shape.

Scot Hoffman: The Financial Sector Committee has spent a lot of time retesting our investment theses over the course of this year. Phil, could you add some color on what the debates have been, and where we're focused?

Phil Barret: Well as you'd expect, Scot, we've had a ton of debate and discussion around financial stocks through the course of the crisis. Some topics have included range of potential credit losses, the impact in duration of low interest rates, the resiliency of capital ratios, the strategy and specific execution of various banks, and relative tradeoffs within the portfolio as fundamentals have changed and valuations have changed. Since the COVID-19 crisis began, we've reviewed and we've underwritten substantially all of the Funds' financial holdings. We've incorporated information from discussions with management, regulators, industry experts. We've stress-tested specific positions, analysing potential credit losses by risk category, and incorporating various interest rate scenarios. We've incorporated a Devil's Advocate that's part of the review process, particularly for underperforming stocks. Finally, we've run a quarterly all-cash exercise for the Finance sector to make sure we're continually re-underwriting the portfolio.

Scot Hoffman: Keiko, in the analysis that Phil mentions and that of the new market dynamics, have we changed any of our views on the Funds' U.S. Financials holdings?

Keiko Horkan: Financials have generally traded down as a group, year-to-date, even with the recent reversal, and we think some are offering exceptional value. For example, Capital One. This is one of our largest holdings in the Financials. Capital One is a scale player in credit cards and auto lending and has invested heavily in technology. Management is focused on the long term and has earned higher risk-adjusted margins than peers over cycle. It also has a robust deposit franchise. We think Capital One is attractive because its valuation relative to the market is at the lowest end of the range. Capital One appears to be well reserved, based on conservative assumptions, and its credit card business is down this year quite significantly, which is Capital

One's most profitable product. And as Phil said, with the resolution of the health crisis, this could reverse, and management is committed to improving its expense efficiency.

Scot Hoffman: Phil, what about the trust banks that we hold?

Phil Barret: So Scot, we hold State Street Bank and Bank of New York. Both are trading at historically low P/E multiples on a relative and absolute basis. Their revenue has been hard hit by low rates, but the banks carry very little credit risk and approximately 80% of revenue is driven by largely recurring fee and other income. So we think revenues should trough next year, as low rates are fully baked into the numbers and from there can probably grow at low single digits. But what's really compelling is the combination of low valuation, high expected capital return, and what we see as low-risk balance sheets. Both banks have significant buffers to regulatory minimum capital levels, so should be able to pay out more than 100% of net income in the coming years, leading to very attractive total yields.

Scot Hoffman: How could a Biden administration's economic policy initiatives impact our Financial Services holdings?

Phil Barret: Well we see three primary impacts. The biggest negative would be a potential for higher corporate taxes, which is less likely if the Republicans keep the Senate. To the positive, we see the potential for greater stimulus, which again will likely need to be bipartisan. The biggest uncertainty is around regulation and how high a priority Financial Services will be for the new administration. This could largely be driven by personnel decisions, so we're watching them closely.

Scot Hoffman: We've seen a lot of technological disruption in Financial Services. Keiko, what is the impact of innovation on companies that we own?

Keiko Horkan: Yes. The Fund's U.S. Financials have been investing heavily in technology. They need to meet their customers' evolving digital banking needs while streamlining middle and back office functions. And with the pandemic, digitisation is accelerating and seems to have [been] pulled forward by two to four years. Large banks spend around 10% of their revenues in technology. Bank of America, J. P. Morgan, and Wells Fargo, for example, all spend over $10 billion a year on technology. That is four times as much as what the next largest banks spend. And as a result, we have seen the larger banks gain market share in deposit gathering and improved expense efficiency.

Scot Hoffman: An analysis of environmental, social, and governance factors is part of our research process, particularly as we think about Financials. And I'm thinking about governance and issues related to governance at companies like Wells Fargo. Could you walk us briefly through those and through how you're thinking about them now, Keiko?

Keiko Horkan: ESG is an important part of our analysis. We look at the mosaic of ESG factors and evaluate them in terms of their potential impact on a company's earnings and cash flow prospects. When we deem these factors to be material, we'll incorporate them into our investment analysis and decision-making process. Wells Fargo is a good example to touch on here. Wells Fargo is one of our largest positions in the Fund. Its sales practice issues surfaced in 2016 and have been under a consent order that includes an asset class since 2018. We have been in constant contact with management and the board. We believe they're an almost entirely new management team. It's the right team for what the bank needs at this moment. They have a strong sense of urgency to make each of their businesses best in class over time. 11 out of the 13 directors today have joined the board since issues surfaced, and the company has revamped its compensation and incentive programs, centralised risk organization, and flattened their org structure among many other initiatives. We'll continue to monitor their progress closely.

Scot Hoffman: In closing, could each of you share your reasons for optimism about U.S. Financials as long-term investors? Let's start with you, Phil.

Phil Barret: Well Scot, we're optimistic for a number of reasons. First, banks are exiting the crisis from a position of strength. Capital and loan loss allowance levels are high. We generally own market-leading franchises that we believe can consolidate market share and grow faster in a recovery. Secondly , evaluations are very low. Cyclically depressed earnings are being capitalised at low multiples relative to the market, and capital return will significantly increase with the lifting of Federal Reserve restrictions. And finally, a lot could change for the better in 2021. Widespread vaccination is expected to largely solve the COVID-19 health crisis through the course of the year. Better economic growth and a steeper yield curve could improve the operating environment for banks significantly.

Scot Hoffman: And Keiko?

Keiko Horkan: Yes, we think the Fund's banks are well positioned to play offense coming out of the crisis. You know, they have a strong capital and liquidity profile, a diverse set of businesses, and scale advantage and ability to make investments over the long run.

Scot Hoffman: Thank you very much, Keiko and Phil, for sharing your perspectives.

Phil Barret: Thanks, Scot.

Keiko Horkan: Thank you.

Scot Hoffman: And thank you for listening.

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