



Investment Perspectives

U.S. Banks: A Compelling Long-Term Value Opportunity

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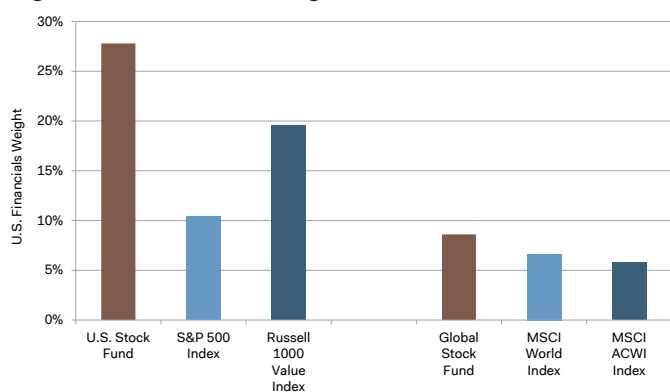
Key Takeaways

- Financial stocks lagged the U.S. stock market in 2020 on concerns that a weaker economy and lower interest rates would lead to higher credit losses and narrower profit margins for U.S. banks.
- Compared to past downturns, we believe the large U.S. banks are in much stronger shape, aided by their solid capital positions and prudent risk taking, as well as robust government support for businesses and consumers.
- The market has heavily discounted the valuations of U.S. Financials, which do not reflect their underlying strength in our opinion.
- Looking ahead, we believe large banks are well positioned to benefit from the vaccine rollout and anticipated economic rebound, which should lead to better growth and lower credit costs in 2021. Low interest rates will likely be a diminishing headwind to earnings in 2021. We expect capital returns to increase, as the U.S. Federal Reserve has allowed all the large banks to resume paying dividends and buying back their shares.
- The Dodge & Cox Worldwide Funds — U.S. Stock Fund and Global Stock Fund are overweight U.S. Financials. We have strong conviction in these holdings^a and believe their long-term risk-reward profiles are compelling at current valuation levels.

In the U.S. equity market, the Financials sector was one of the worst performers in 2020. While the overall market posted double-digit returns, Financials declined amid concerns over credit and interest rate risk. When the economy faltered in the spring under the weight of global coronavirus (COVID-19) pandemic lockdowns, many investors made two assumptions: 1) that banks would suffer significant credit losses, and 2) that the ultra-low interest rates would squeeze margins.

However, in our view, those investors overestimated the damage the recession would cause financial services companies and underestimated the underlying strength of their businesses and potential to deliver strong returns in a post-pandemic economic recovery. In this paper, we will explain why the Dodge & Cox Worldwide Funds — U.S. Stock Fund and Global Stock Fund have significant exposure to U.S. Financials (see Figure 1), even at a time of prolonged low-interest rates. We will use the Funds' holdings of large U.S. banks to make that case.

Figure 1: Funds Are Overweight U.S. Financials^b



Source: FactSet, LSE Group, MSCI, and S&P.

Why This Downturn Is Different

The last time the U.S. economy contracted—during the 2008-2009 global financial crisis—bank stocks fell sharply. Many were heavily exposed to the housing market, which was the epicenter of the downturn. In subsequent years, regulatory changes in response to the crisis led to a step-function decline in return on equity across the sector.

In contrast, most U.S. banks entered 2020 with low leverage, restrained risk taking, and well-diversified revenue sources. The banking industry's resilient profitability through the downturn validated post-crisis reforms.

But that is not the only contrast between now and then. The nature of the downturn itself is different and so have been the policy responses. Fundamentally, the pandemic is a health crisis that led to a sudden stop in economic activity. The U.S. government stepped in quickly with the CARES Act, a \$2.2 trillion relief package to help struggling businesses and consumers, and passed a \$900 billion second round of stimulus in December. By all accounts, the U.S. economy shrank in 2020 but not nearly as much as forecasters originally feared. The upshot: U.S. banks overall have remained profitable, built capital levels, and supported the real economy through the crisis.

In anticipation of a sharper downturn, many banks set aside significant provisions for expected credit losses in 2020. As a result, they are broadly reserved for higher levels of joblessness than the United States is currently experiencing. Unless the economic outlook deteriorates, that should mean large banks will not have to build additional reserves and, in fact, some could release reserves in 2021. In December, all large U.S. banks passed the Federal Reserve's off-cycle stress test and were granted permission to return 100% of their average last four quarters' profits through dividends and share buybacks in the first quarter of 2021.

Finally, the large banks have benefited from unexpected strength in a number of business lines. Revenues from capital markets trading and mortgage banking have been robust. In terms of collateral backing loans, price levels for homes, used cars, and equities have all remained resilient.

Suffice it to say this has been an unusual economic crisis, and the large banks are, in our opinion, positioned to emerge from it much stronger than they did following the global financial crisis.

Why We Are Optimistic About The Funds' U.S. Financials Holdings

We believe that market views of banks will change for several reasons.

- **Earnings are bottoming out:** As we have noted, banks front-loaded loan loss provisions in 2020 to levels that now appear conservative. We believe that low U.S. interest rates should be a diminishing headwind in 2021, unless the yield curve were to reverse course from its recent steepening.
- **U.S. Financials are trading at inexpensive valuations:** Financials' valuations are near historic lows compared to the stock market as a whole (see Figure 2). The S&P 500 Banks industry trades at 13.4 times forward estimated earnings compared to 23.7 times for the broader S&P 500 Index. This large discount supports the value case for bank stocks.

Figure 2: The U.S. Financials Sector Is Trading Near Its Lowest Relative P/E Ratio



Source: FactSet.

- **Potential for capital returns to increase significantly:** Amid the pandemic-induced downturn in early 2020, the Federal Reserve temporarily restricted bank payouts by barring stock buybacks and capping dividends. Now that those restrictions have been largely lifted, banks are better positioned to deliver high total yields through a combination of rising earnings and high dividend and buyback payouts. In a low-rate environment, high absolute yields support a valuation re-rating.
- **Optimism that vaccines will boost the economy:** As more Americans get vaccinated in 2021, the potential exists for a virtuous cycle of rising consumer demand and stronger corporate investment. This, in turn, could lead to a steeper yield curve, which would benefit bank net interest margins.
- **Ability for strong banks to become stronger:** We generally invest in leading franchises, many of which have gained deposit market share and improved efficiency in recent years (see Capital One^e sidebar). Their advantage stems in part from heavy investments in technology. Bank of America and J.P. Morgan, for example, have both spent over \$10 billion a year on technology to meet the evolving digital needs of their customers. These two banks and many others have navigated the pandemic

well, as digitisation accelerated, and we expect them to continue to gain share in the recovery. Bank of America and J.P. Morgan, for example, have both spent over \$10 billion a year on technology to meet the evolving digital needs of their customers. These two banks and many others have navigated the pandemic well, as digitisation accelerated, and we expect them to continue to gain share in the recovery.

The Role of ESG

As fundamental investors, we are focused on all factors that can affect a company's performance. Therefore, environmental, social, and governance issues (ESG) are an important part of our analysis. In the banking realm, Wells Fargo, one of the Funds' largest positions, is an example of how we integrate ESG factors into our research process.

In 2016, reports surfaced alleging that Wells Fargo had created accounts without the consent of customers. The reports drew the attention of politicians and regulators and resulted in substantial fines, tougher regulatory scrutiny, and significant turnover in the bank's executive ranks and board of directors. Wells Fargo's management team is almost entirely new and 11 of the 13 current directors have joined the board since the problems arose. The bank subsequently revamped its compensation and incentive systems, centralised its risk functions, and flattened its operating structure. We remain in continuous contact with the company to maintain a clear understanding of the management team's priorities and developments. In our judgement, the bank now has the right leadership team, with a strong sense of urgency to return the business segments to best-in-class over time. We remain investors in Wells Fargo's stock, and we continue to monitor management's progress closely.

Political Risk

The new Biden Administration has taken office in Washington, which could affect U.S. banks. As a candidate, President Biden supported higher corporate taxes, which would be negative for the Financials sector. It remains to be seen whether Biden will prioritise tax reform, and if so, whether Congress will pass related legislation. We are closely watching the administration's personnel decisions, which will shape regulatory oversight. In the meantime, the \$900 billion COVID-relief bill passed by Congress in December should help the economy and U.S. banks.

Our Rigorous Investment Process

In keeping with our well-established processes, we have examined and reevaluated the Funds' financial services holdings continuously throughout the pandemic to retest our investment theses. We have explored the impact of low-interest rates, higher credit losses, and the resilience of capital ratios at each company in which we invest. We have also stress tested each holding under a range of scenarios. In our Sector and Investment Committee meetings, we have held rigorous debates, employing a devil's advocate to challenge our investment theses. All of these steps have reinforced our confidence in the strength of the Funds' U.S. Financials holdings.

Capital One Financial

Capital One, the U.S. Stock Fund's largest holding, fits the mold of what we are seeing across the Financials sector. It is a leading franchise trading at an attractive valuation and, in our opinion, represents exceptional long-term value.

Capital One's most profitable business—credit cards—felt the impact of weaker consumer spending as the pandemic took its toll on the economy. Yet, like many other Financials, it is well positioned to benefit from a healthier economy that we believe should emerge once vaccinations become widespread. The company has a number of strengths: scale in credit cards and auto lending, a robust deposit business, and advanced digital banking platform due to its heavy investment in technology. Management is focused on the long term, committed to improving the bank's expense efficiency, and has a track record of earning higher risk-adjusted margins than its peers.

At 11 times forward earnings, Capital One is trading at a substantial discount to the overall market. If history is a guide, this low valuation is good news for investors. In the past when Capital One has been unusually inexpensive—e.g., in 2002 when the credit card industry faced subprime challenges, and in 2009 during the global financial crisis—it strongly outperformed when the economy rebounded.

In Closing

We cannot say with any precision when other investors will come around to our view of U.S. financial services stocks. But we are confident that the U.S. banks held in the Funds represent attractive long-term investments for the reasons we have outlined: valuations are inexpensive, fundamentals are resilient, capital returns will potentially rise, and there is optimism that widespread vaccination will lead to a stronger economy and a better operating environment for the banks, especially the industry-leading franchises that we favour.

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- a As of 31 December 2020. Dodge & Cox Worldwide Funds – U.S. Stock Fund (% of Fund's net assets): American Express (1.5%), Bank of America (2.8%), Bank of New York Mellon (2.2%), Brighthouse Financial (0.4%), Capital One Financial (4.1%), Charles Schwab (3.8%), Goldman Sachs (2.1%), JPMorgan Chase (1.4%), Lincoln National (0.4%), MetLife (2.9%), State Street (1.4%), Truist Financial (1.1%), and Wells Fargo (3.8%). Dodge & Cox Worldwide Funds – Global Stock Fund (% of Fund's net assets): Bank of America (0.8%), Bank of New York Mellon (0.8%), Capital One Financial (2.2%), Charles Schwab (1.4%), MetLife (0.7%), and Wells Fargo (2.6%).
- b Unless otherwise specified, all weightings and characteristics are as of 31 December 2020.
- c The use of specific examples does not imply that they are more or less attractive investments than the portfolio's other holdings.