



European Financials

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 European Financials, an area of the market that has reflected significant pessimism but one in which Dodge & Cox sees very attractive long-term investment opportunities. We'll also touch briefly on the opportunity we see in U.S. Financials. I'm joined by Phil Barret, a member of the U.S. Equity Investment Committee, the head of our Financials Sector Committee, and a Global Industry Analyst whose coverage includes asset managers and UK banks. Welcome, Phil.

Phil Barret: Thanks, Scot.

Scot Hoffman: Rameez Dossa is also joining us. Rameez is our Global Industry Analyst covering European banks. Welcome, Rameez.

Rameez Dossa: Thanks, Scot.

Scot Hoffman: Let's start with a broad question for you, Rameez. We recently published a paper which we called "The Value Investor's Case for European Financials." Can you tell us a little bit about the impetus behind the paper?

Rameez Dossa: I think there are three primary reasons why we published this paper. First and foremost, as a firm, we have a material overweight to European and UK Financials in both our International Stock Fund and our Global Stock Fund. Second, we wanted to use this as an opportunity to illustrate our investment process and to show where and why we're seeing value-oriented investment opportunities. And third, even though we construct our portfolios on an individual stock by individual stock basis, we often find themes that coalesce around these sectors and we wanted to explain that further. More broadly, European Financials is an area where there is a deep amount of pessimism, as reflected by current valuations, while the fundamentals of the industry have and continue to improve. And that's why we see very compelling longer-term risk/reward investment opportunities here.

Scot Hoffman: Phil, let's talk a little bit about valuations. When you look across the sector, why do you think they're so low?

Phil Barret: I think it's a couple things. You know, the two big categories are current operating conditions and then geopolitical concerns. So in terms of operating conditions, they're not great in Europe right now. Interest rates are low. They're expected to fall further. Growth in Europe has been sluggish in capital markets conditions, which are important to banks like Credit Suisse and UBS and Barclays. And the French banks, BNP and SocGen (Societe Generale), have been generally poor as well. We've seen in the fourth quarter of last year, equity markets had a big drawdown and subsequent to that, we saw a freezing in capital markets and primary markets. More recently, volatility has been low across asset classes and volumes have generally been sluggish. So there's not really a lot to get excited about on the revenue side, and that's causing a long shadow over the industry to be cast. The other big factor is geopolitical fears. So we're seeing that in Europe, specifically with Brexit and rising uncertainty around the UK's exit from the European Union. We're also seeing that in the China/U.S. trade negotiations and we'll see how those play out, but the threat of trade wars, and also, just general rise in populism in recent years in certain European countries. So you put those things together and it's just not a very constructive environment to

grow revenues as a financial in Europe.

Scot Hoffman: Let's come back to the macro environment in a minute. Before we do that, Rameez, what do you see when you look at the fundamentals of a particular bank and what the market's missing overall? In other words, how do we actually analyze an individual bank?

Rameez Dossa: The starting point for evaluating European banks is consistent with how we evaluate securities in general, which is we always start with valuation. Valuations for European banks are close to 10-year lows today, at about eight times forward price to earnings. If we look back at periods of time when European banks traded at these levels, it was during periods of extreme distress like the global financial crisis and the sovereign debt crisis. And in our assessment, the fundamentals of these banks that we're invested in are very different and vastly improved today. As with any investment, we first of all ask ourselves the question how could we lose a lot of money here? What is the probability of permanent loss of capital? And with banks, our observation over time has been that banks generally get themselves in trouble over liquidity issues. And so we've spent an immense amount of time starting with the liability side of banks' balance sheets and understanding their funding models and understanding their liquidity profiles. And, across the board for banks that are in our portfolios today, we find that liquidity profiles and funding profiles are step-functioned better today than they were five years ago and ten years ago. On top of that, capital levels for these banks have essentially doubled over the last decade, which has further improved the resilience of these banks in a potential downturn. And so we believe that downside protection today is vastly improved compared to any other period of time when these banks were trading at such distressed valuations.

We then switch our focus to the profitability side of the equation. How can we as investors make money over the long term? If we look at the returns on equity that banks, as an aggregate matter, are earning in Europe today, they're earning about an 8% return on equity. That is about half the level that they used to earn before the financial crisis. Obviously the world has changed in terms of banks having to hold far more capital today than they used to, and also the interest rate environment is very different in that interest rates have come tumbling down and that has been a headwind to bank profitability. On top of that, banks in Europe have gone through an extended period of restructuring, and that has been quite expensive because that has required taking losses for reducing non-performing loans, it has required taking losses for layoffs, branch closures and so on, and so all of those factors in aggregate have translated into the picture that we see today of about 8% return on equity.

From today's point, the banks that we're invested in as an aggregate matter are targeting about a 10% return on equity over the next two to three years. And the drivers of that are largely self-help, which is that banks are cutting costs while investing in IT and digital technologies, and they are slowly but surely exiting lines of business that are either subscale or unprofitable and improving capital allocation. It's that combination of events or combination of actions that is driving the bridge from about 8% return on equity today to 10% return on equity. All of that is predicated upon an assumption that interest rates will likely continue to be quite low. And so low interest rates, which is a major theme for investors today, are not new news and by and large reflected in the way banks are planning their business targets. If there is any improvement in the interest rate environment, which we think is a non-zero probability over the course of our four- to five-year type investment horizon, that would be a massive boost to the bottom line for these banks, and, and would be basically upside optionality that we're not paying for today.

Scot Hoffman: So it sounds like you've got a lot of optimism about the specific banks in the portfolio, but both you, Rameez, and Phil I know recently were at on a research trip in Europe and I think you used the word "dour" to describe the mood at that meeting. So I hear the optimist case. How do you reconcile that with the mood that you experienced in Europe and how does that give you optimism?

Phil Barret: Rameez and I were in Paris recently and the mood in the investment community is absolutely dour. It's glum. It's extremely pessimistic. I think expectations are near rock bottom. And why is that the case? I think again it gets back to these kind of macro overhangs and geopolitical concerns. You know, the bigger issue is people just haven't made money in this sector over the long term. Whether we look at it over the last 5 years or 10 years or 20 years, it's been a really, really challenging place to deliver shareholder returns. And cumulatively that builds up and people have negative experiences and that gets expressed in how they view the industry, how they position their portfolios. But what we try to do is carefully look at what we're buying and what we're paying for. And, when we do the work on vectors that Rameez spoke about and others we can go into, the banks are

in demonstrably better shape today. And it's a situation where we try to use our time horizon to our advantage. So particularly with some of these macro and geopolitical factors, things are very pessimistic today but they can change over time. We're not underwriting them to significantly change under time, but things like interest rates, things like regulatory tone, are dynamic. They aren't static. And we think we're getting some pretty cheap options around improvement. And if things don't improve, building on Rameez's point, I mean, these banks are trading at generally seven times earnings and paying 6% dividend yields. So we think we potentially have the investment trifecta of very low valuation, current valuation, where if you think about the probability—from seven times earnings—of multiple increases is probably greater than multiple decrease. [Secondly], you have high current capital return. On average, we have 6% dividend yields, plus for many of these banks they're buying back shares so total returns are even higher. And thirdly, we think we have the potential for earnings growth. You know, these banks have been, as Rameez spoke about, been working furiously to cut costs and improve efficiency and right size their organizations to the reality. And it has been slow going but we can track progress over time and we think the banks have made it.

Rameez Dossa: I would echo what Phil just highlighted and the one area I would add is there seems to be a disconnect in many ways between the types of questions that investors seem to be focused on and what the banks are actually doing from an operational perspective at the moment. So, investors are extremely focused on the yield curve, [it] has risen and fallen, risen and fallen, and has fallen again and been quite low. How will that hamper banking profitability? How will banks actually be able to earn reasonable returns in equity through that environment? The interesting thing about that is that it's not new news. Interest rates in Europe have been low for now a few years, and the yield curve is amply public for both investors to see but also bank management teams to see. And so what bank management teams are solving for is self-help to improve profitability rather than relying on the macro environment to bail them out. So if you look at the business plans that we're invested in, by and large they incorporate pessimism on the interest rate curve. And so what the banks are solving for is measures like becoming more cost-efficient, taking a hard look at the mix of their business lines and looking at areas that are low returning that could be exited over time, and thinking very hard about capital allocation. And so there's, in some ways, a big macro overhang on this part of the market, but under the hood, the people who are actually operating these businesses, while being very cognizant of the macro environment in which they operate, are taking actions that we think have a reasonable probability of generating longer-term value for investors. And to Phil's point, we are, in some ways, using our time horizon as a way to stomach what is a very difficult time period and wait for a period in—call it a four- to five-year type time horizon, where some of these self-help measures will find a way to work their way through profitability.

Scot Hoffman: So patience is a big part of the investment thesis.

Rameez Dossa: Yes.

Scot Hoffman: Phil, since you're on an Investment Committee, let's discuss portfolio construction. We focus on individual stock selection so how does the Investment Committee think about the macro environment and then factor that into how we build our investment portfolios, and how would we even answer the question: isn't an overweight in European Financials akin to a macro bet?

Phil Barret: Well it's a good question, Scot, and as we think about risk management and think about how macro factors are incorporated into the risk profile of an investment, there's multiple things we take into consideration. First, thinking through risk management, I think on a fundamental basis valuation is one of our key tools and that low values provide some sort of margin of safety and risk mitigant, and that paying a very low price for something, [the] probability [that] it goes down in value versus up, is different. And we spend a lot of time through deep research and incorporating the macro risks and thinking about the macro risks. So, on a bottoms-up basis, we work to understand the impact of slower economic growth or lower interest rates or weaker capital markets activity on a bank in understanding what the durability of the earnings are, whether the bank can kind of make it through a rough patch or not. We have an extensive fixed income and macro effort and team and we draw upon resources throughout the firm to better understand the possibilities and probabilities around macro outcomes. And we also have a commitment to maintaining a diversified portfolio, so we have a significant overweight. But if we look at it on a granular basis, we own stocks like Standard Chartered that have very little to do with Europe, whose future is tied largely to emerging markets. We own Credit Suisse and UBS in Switzerland. You know, one,

Switzerland is not part of the European Union, but two, their significant businesses, many of them are outside of the continent of Europe and their future will likely be more driven by wealth creation in emerging markets than Europe. So there are a lot of ways we try to incorporate macro factors and risks, but generally, that is not central to our investment theses.

Scot Hoffman: There are two companies in particular that were in positions in both the International and the Global Stock Fund as at the end of the second quarter: BNP Paribas and UBS. Rameez, maybe walk us through the BNP investment case first?

Rameez Dossa: Sure. BNP Paribas is trading at around seven times forward earnings today. These were levels last seen during the global financial crisis and the sovereign debt crisis. What's interesting about the fundamentals of this bank is that, despite what has been a very onerous operating environment over the last decade, BNP's profitability has proven to be quite resilient. If we look at per-share book value creation over the last decade—and we define that as growth in book value per share plus cumulative dividends per-share paid over time—BNP has been one of the highest compounders of per-share book value amongst European banks over the last decade. In terms of business mix, about three quarters of BNP's profitability comes from its highly stable and profitable pan-European retail and asset management businesses. The remaining 25% or so comes from its investment banking business, which is an area that the bank is in the midst of restructuring and exiting certain lines of business which were either subscale or generated low returns on equity. And more broadly, this bank is in the midst of a restructuring plan that entails cutting costs while investing in digital banking and, as I mentioned, streamlining its investment banking operations. If you add it all up, the bank today is earning a roughly 8% return on equity and the target in getting to 9.5% by 2020, again incorporating realistic assumptions about a tough external macro operating environment. So when we consider these fundamental attributes of the bank in the context of today's low valuation, we feel that the risk/reward proposition is quite attractive.

Scot Hoffman: Phil, how about UBS? Why do we own UBS?

Phil Barret: So UBS in the departure point is valuation. It's very cheap stock. It's trading at about nine times earnings today, and it's returning a lot of those earnings. The stock is yielding 6% dividend yield plus another 2% of the market cap returned annually with buybacks, so kind of 8% total yield. So it's cheap. It's yielding a lot and it's a great business. It's core business, its business mix is the envy of other banks. It has the leading wealth management business in the world, which is a high return on equity business, which is levered to global wealth creation, and which benefits from scaled manages in terms of brand, IT systems, compliance, product procurement. So it's at its core a great business mix at a very low valuation with high capital return. So why is it so cheap today? It's at a tough part in the cycle, is the primary reason. You know, recently, as we discussed, markets went down significantly, equity markets, in the fourth quarter of last year. Client risk-taking has not come back in a big way. Clients tend to be quite cautious around these geopolitical concerns. At the same time, lower global rates are bad for UBS and in its wholesale business and its equities and fixed income trading business, volumes, and volatility have been pretty weak. So it's not a great revenue environment but as we look at it, it is a point in the cycle. You know, over the longer term, this is an organization levered to wealth creation, particularly in emerging markets and faster growing parts of the world. And if anything, the barriers of entry in this business are increasing, given rising compliance requirements and rising regulatory requirements on a global basis. So we think over the long term this will be a growing business with a high return on equity that today we are owning for a very low valuation.

Scot Hoffman: Let's turn to the U.S. for a minute. We're overweight Financials in the U.S. Stock Fund. What's the thesis there, Phil?

Phil Barret: Well as we look at banks today in the U.S., similar to Europe they're at very low historical valuations. Our holdings in the Stock Fund generally trade between 8 and 11 times earnings. Relative to the S&P 500, large cap U.S. bank stocks are pretty much as cheap as they've been outside of the dot-com bubble in the late nineties. So the valuations are quite cheap and capital return for U.S. banks is very high. The holdings that went through the CCAR process recently in June got permission to return on average 11% of their market caps in the coming year through dividends and buybacks. So as we think about that, being spotted 11% up front in terms of capital return we find enormously compelling in the current market. And bank fundamentals continue to be strong in

the U.S. You know, loan growth is low-to-mid-single digits, capital levels are strong, return on equity is high and improving, and we particularly see opportunities in some of the biggest banks like Wells Fargo and JPMorgan and BofA (Bank of America), which are growing faster and using scale advantages in IT and marketing to gain share against smaller banks. And another plus for U.S. banks is regulatory pressures have been subsiding under the new administration. The big overhang and really development over the past few months, has been the collapse in the yield curve in the U.S., which is negative for bank earnings, but we think that the banks have adequate defenses in terms of growing volumes and fee income, increasing fee income, and cutting costs. And also would note that interest rates are dynamic and we kind of would rather look at a range of outcomes rather than a point estimate on the future direction.

Scot Hoffman: We think at these valuations the significant portion of the adverse impact of interest rates is already priced in.

Scot Hoffman: That's all we have time for today. Thanks, Phil and Rameez, for sharing your thoughts with us and thank you for listening.

Rameez Dossa: Thank you.

Phil Barret: Thank you.

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