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Finding Value in European Banks

Kevin McDevitt: Hi, I'm Kevin McDevitt. We're at the Morningstar Investment Conference. I'm here with Charles Pohl from Dodge & Cox. Charles, thank you for joining us.

Charles Pohl: You're welcome.

Kevin McDevitt: Charles, Dodge & Cox is known very much for its patient approach to investing. How do you get comfortable with the company's long-term prospects? How do you get comfortable with making that long-term commitment to a company?

Charles Pohl: I think it really involves an intense research process, a strong focus on fundamentals. You want to make sure that you understand what the long-term objectives are of the management; their alignment with building shareholder value; the strength of the business franchise and its potential for growth and earnings and cash flow.

Kevin McDevitt: How do you move beyond, though, just projections? If you're looking at a five-plus year commitment, I'm interested in going beyond projections at that point. Are there more intangible factors you're looking at as well?

Charles Pohl: Yeah. One of the ones I mentioned was the strength of the business franchise, so I think you want to understand some basic things about the nature of the business. How differentiated are the products? How competitive is the business? How many competitors are there in the business? What's the level of price competition? How many customers and suppliers are there? You're less interested in businesses that have a very small number of competitors, where they may have a lot of leverage in any kind of pricing negotiation or a very small number of suppliers. You'd prefer to have lots of suppliers and lots of customers and very few competitors. You want to really get some understanding about the structural dynamics of the business, the strength of the business franchise.

Kevin McDevitt: Sure. This is perhaps shifting gears a bit. In your global portfolio, you have a fairly large weighting to emerging-markets stocks.

Charles Pohl: Yes.

Kevin McDevitt: Do you find any of those companies with strong franchises in emerging markets?

Charles Pohl: Yes, you do. I think that taking a fundamental research approach, a long-term value-oriented approach in emerging markets may be even more beneficial than it is in the more developed markets. The reason is that there is a much wider range of kinds of businesses, and particularly a much wider range of governance and alignment with shareholders in a lot of the emerging-markets companies. In many countries, the rule of law is much weaker than it is in the United States. Accounting standards are sometimes shakier than they are in the United States. So I think the investor can really benefit a lot more even from deep fundamental research than they might in the developed market.

Kevin McDevitt: What are some of the opportunities you've found in emerging markets? What are some of your favorite ideas there?

Charles Pohl: Well, some of the ones that we're invested in—we've got a number of financials that I think are very strong companies. For example, ICICI Bank in India, or Itau in Brazil. In both of those cases, what's interesting is—and it's true in a lot of emerging markets—you have a lot of state-owned banks, and then you have some private banks. The state-owned banks are often very poorly run. They're often not run for the benefit of the long term shareholder. They often have, and in Brazil and India you see this, public shareholder bases. When you've got a focused management team, a private institution that is focused on trying to build long term value--especially in a situation like Itau, where you have families that have owned the bank that are also deeply involved with the management, so a very strong alignment with the shareholders and building long term shareholder value--they can have a lot of success because they've got these competitors who are not terribly focused.

Kevin McDevitt: Speaking of banks, you also own some European banks. There's a lot of concern these days about the fiscal situation in countries like Italy, France, and other parts of Europe. Talk about the prospects for some of these banks and how you got comfortable with them despite these overhangs.

Charles Pohl: I think there are some serious fiscal issues in some of the European countries. In some countries, the fiscal issues and the banking issues are so serious that we've avoided them. For example, Greece. But we do have UniCredit in Italy, which the Italian government does certainly have some fiscal problems and some political issues as well, I think. France. We've got BNP, and the French fiscal situation is problematic, also. The political situation seems like it's going to go in a good direction, but there is some uncertainty there in terms of the presidential race. The way we get comfortable is if you look at UniCredit or BNP, you see companies that have significantly bolstered their capital ratios, where we believe that the management team is interested in doing the right things, building shareholder values, generating earnings for the shareholders. The liquidity situation at both of those companies is improved significantly. The credit situation has improved, and one thing that people note about the European banks--and one of the reason they trade at low valuation multiples, which is also a very attractive thing and is part of why we're in them is because those countries have problems but we think that it's discounted in the price of the stocks--is that very slow loan growth, as you haven't really had any significant loan growth for quite a few years, but that has allowed them also to greatly improve the credit quality of the banks. You've had write-offs and sale problem loans, and so they've cleaned up their balance sheets a lot. Going forward, it's going to be easier to earn money because you're not going to have the drag from problem credits that you've had.

Kevin McDevitt: Great. Charles, thank you for your insights.

Charles Pohl: Thank you for having me.

Kevin McDevitt: Thank you for watching.