DODGE & COX®

Investment Perspectives

A Value Investor's Case for European Financials

APRIL 2019

KEY TAKEAWAYS

- Prices of European and UK Financials stocks declined in 2018, largely driven by macro and political concerns.
- Overall valuations reflect deep pessimism, even though fundamentals have improved, as evidenced by stronger balance sheets, higher capital levels, and increased profitability.
- The Dodge & Cox International Stock Fund and Global Stock Fund are overweight European and UK Financials.
- We retested our investment theses—weighing both macro and company-specific factors—and believe the long-term risk-reward of the Funds' European and UK Financials holdings is very attractive at current valuation levels.

Over the past decade, European and UK financial institutions have faced many challenges, including the global financial crisis (2008-09), European sovereign debt crisis (2011-12), and an environment of slower economic growth, prolonged low interest rates, and political uncertainty. More recently, concerns about the United Kingdom's exit from the European Union (Brexit), political turmoil in Italy, protests in France, and slowing global economic growth have weighed on bank share prices.

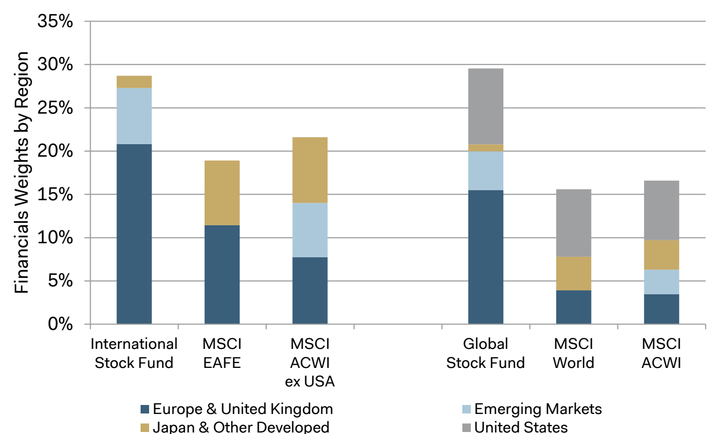
Given such market pessimism, why do the Dodge & Cox International Stock Fund and Global Stock Fund have significant exposure to European and UK Financials (see Figure 1)? While our Investment Committees build diversified portfolios one investment at a time across geographies, sectors, and industries, our individual security selection points to a broader sector theme. We believe the Funds' European and UK Financials investments[a] represent some of the best long-term opportunities available today.

Our conclusion is based on a thorough reassessment of our investment theses, weighing both the risks and opportunities of each company. Our global industry analysts have retested our views by incorporating input from our macro research team, learnings from industry conferences, and insights from meetings with senior management teams of these companies, competitors, regulators, central bankers, and policymakers.

WHY VALUATIONS ARE COMPELLING

When fear and uncertainty dominate the headlines, valuations are often driven to levels that incorporate significant downside risks. This type of environment can create a long-term investment opportunity for value-oriented investors like Dodge & Cox. Utilizing deep fundamental research, we seek to understand a company's business model, competitive positioning,

Figure 1: Funds Are Overweight European and UK Financials[b]



Source: FactSet, MSCI.

and financial strength in a wide variety of scenarios. This work often gives us the conviction and confidence to invest when companies and sectors are out of favor, as is currently the case with European banks.

Valuation metrics (e.g., how much one pays now for partial ownership of a business relative to its potential future earnings power or cash flow generation ability) are helpful in assessing investor sentiment. In our view, current valuation levels of European and UK banks, at eight times forward earnings and close to 10-year lows, reflect significant pessimism about the future. We have extensively assessed the macro environment and company-specific risks, and believe the fundamentals of our carefully selected holdings tell another story.

FUNDAMENTALS HAVE VASTLY IMPROVED

Fundamentals have improved across the Funds' European bank holdings ("Holdings"), driven by management actions to strengthen balance sheets, build capital, and increase profitability. Going forward, we believe these Holdings can improve profitability largely through self-help initiatives, such as cost cutting, exiting sub-scale business lines, and digitalization. While our baseline expectation is for a prolonged period of low growth and low interest rates in Europe, any improvement in the macroeconomic backdrop, in particular higher interest rates, could drive further upside.

Stronger Balance Sheets

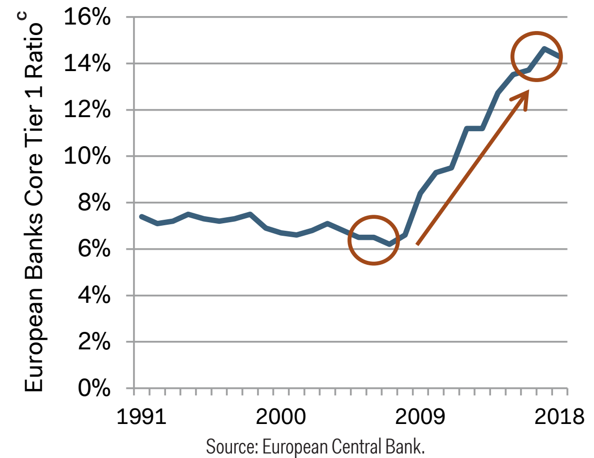
Over the last decade, the management teams at a number of European banks have overhauled their balance sheets, reduced leverage, and lowered credit risk, as evidenced by tighter lending standards and slower loan growth. In aggregate, these actions have substantially reduced the probability of outsized credit losses should economic conditions deteriorate.

On the liability side of the balance sheet, the Holdings have substantially improved their funding profiles, replacing shorter-term wholesale funding with more stable customer deposits. These companies have also built substantial liquidity buffers in excess of short-term funding needs, providing protection if access to capital markets tightens.

Higher Capital Levels

Capital levels at European banks have doubled over the last decade (see Figure 2). Moreover, as regulations have evolved, the quality of capital has improved due to (1) tougher classifications of what qualifies as capital and (2) higher risk weights. The Holdings have sufficiently capitalized, well-funded, and highly liquid balance sheets today, creating better downside protection than in prior cycles.

Figure 2: Capital Ratios Have More Than Doubled



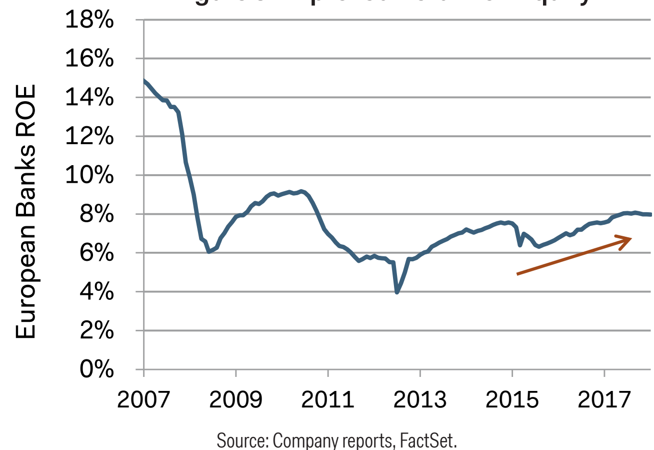
Source: European Central Bank.

Increased Profitability

Return on equity (ROE) for European banks halved between 2007 and 2015, driven by higher capital requirements, loan losses, and restructuring costs. The operating environment for European banks continues to be challenging. In addition to multi-decade low interest rates, earnings are depressed by capital markets revenue declines and regulatory headwinds.

In recent years, ROEs have modestly improved as the expense of fixing balance sheets has declined and banks have started cutting costs to offset headwinds from low interest rates and higher capital requirements. The Holdings are collectively generating approximately 8% ROEs today and targeting approximately 10% ROEs by 2020-21, largely to be achieved through self-help measures like cost cutting, exiting low-return sub-scale businesses, and further shifting their business models towards fee-generating businesses that consume less capital. In addition, the Holdings have been investing heavily in technology in order to meet their customers'

Figure 3: Improved Return on Equity



Source: Company reports, FactSet.

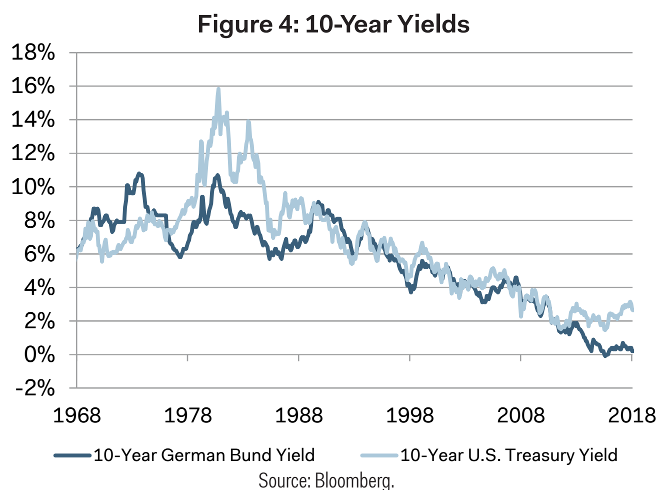
evolving digital banking needs while streamlining middle- and back-office functions.

Furthermore, companies are increasingly returning capital to shareholders in the form of dividends and share repurchases, while preparing to meet future regulatory capital requirements. Current dividend yields for the Holdings are quite attractive (6% yield on average).

Potentially Higher Interest Rates

Interest rates remain extremely low in both Europe and the United States in a historical context. While our baseline assumption is that interest rates will likely remain low in Europe for a prolonged period, any increase in interest rates could create significant upside for the Holdings. Importantly, we are not paying for this upside optionality given inexpensive starting valuations.

Figure 4: 10-Year Yields



Source: Bloomberg.

FINDING VALUE THROUGH INDIVIDUAL SECURITY SELECTION

Based on their investment merits, we have added to selected companies over the last year, including BNP Paribas[d] (a French-domiciled, pan-European retail and investment bank) and UBS (the world's largest private bank and wealth manager, based in Switzerland). These companies illustrate how we look beyond macro concerns to unearth value opportunities.

BNP Paribas

BNP Paribas (BNP) is trading at seven times forward earnings—levels last seen during the global financial and European sovereign debt crises. Despite difficult market conditions, BNP's profitability has proved to be resilient. Over the last decade, BNP has been one of the highest compounders of value per share (growth in book value and dividends) among European banks. Its highly stable pan-European retail and asset management businesses generate three-fourths of the bank's profits. BNP has improved its funding profile by increasing its mix of stable deposits and reducing its reliance on short-term wholesale funding. The bank is in the midst of a restructuring plan that entails cutting costs, investing in digital banking, and streamlining its investment banking operations, with the goal of increasing its ROE from 7.8% today to 9.5% by 2020. Considering these fundamental attributes in the context of the company's low valuation, we believe the long-term risk-reward outlook is attractive.

UBS Group

At nine times forward earnings, UBS trades near its lowest valuation since the European debt crisis, while the company is in a much stronger financial position. UBS has successfully restructured its investment banking division and boosted capital levels. All of its businesses generate a healthy ROE, and the wealth management business appears well positioned to grow, especially in Asia. Looking forward, we believe the company will be able to return more capital to shareholders through dividends and share repurchases. In addition, the CEO has purchased meaningful amounts of shares, further aligning management's interests with those of shareholders.

IN CLOSING

We are enthusiastic about the long-term outlook for the Funds' European and UK Financials investments. These companies are more resilient today than they were in previous periods of economic stress when valuations were at similar levels. They have greatly improved their underlying fundamentals, strengthened their balance sheets, and increased capital ratios, while pursuing self-help measures to improve profitability. Although our investment theses are not predicated upon improving macro conditions, we believe any increase in interest rates over our investment horizon could generate further upside.

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a As of March 31, 2019. International Stock Fund (% of Fund's net assets): AEGON (1.0%), Aviva (1.4%), Banco Santander (2.1%), Barclays (2.1%), BNP Paribas (2.6%), Credit Suisse Group (1.9%), Lloyds Banking Group (1.5%), Societe Generale (1.7%), Standard Chartered (1.5%), UBS Group (2.5%), and UniCredit (2.4%). Global Stock Fund (% of Fund's net assets): AEGON (0.6%), Aviva (1.0%), Banco Santander (1.7%), Barclays (1.6%), BNP Paribas (2.0%), Credit Suisse Group (1.5%), Societe Generale (1.6%), Standard Chartered (1.4%), UBS Group (1.9%), and UniCredit (2.2%).

b Unless otherwise specified, all weightings and characteristics are as of March 31, 2019.

c The Common Equity Tier 1 ratio (CET1) is a measure of bank solvency that gauges a bank's capital strength. Common Equity Tier 1 ratio = Common Equity Tier 1 Capital / Risk-Weighted Assets.

d The use of specific examples does not imply that they are more or less attractive investments than the portfolio's other holdings.

The MSCI EAFE (Europe, Australasia, Far East) Index is a broad-based, unmanaged equity market index aggregated from 21 developed market country indices. The MSCI World Index is a broad-based, unmanaged equity market index aggregated from 23 developed market country indices, including the United States and Canada. The MSCI ACWI (All Country World Index) Index is a broad-based, unmanaged equity market index aggregated from 46 developed and emerging market country indices. The MSCI ACWI (All Country World Index) ex USA Index is a broad-based, unmanaged equity market index aggregated from 45 developed and emerging market country indices, excluding the United States. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This publication is not approved, reviewed, or produced by MSCI.

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