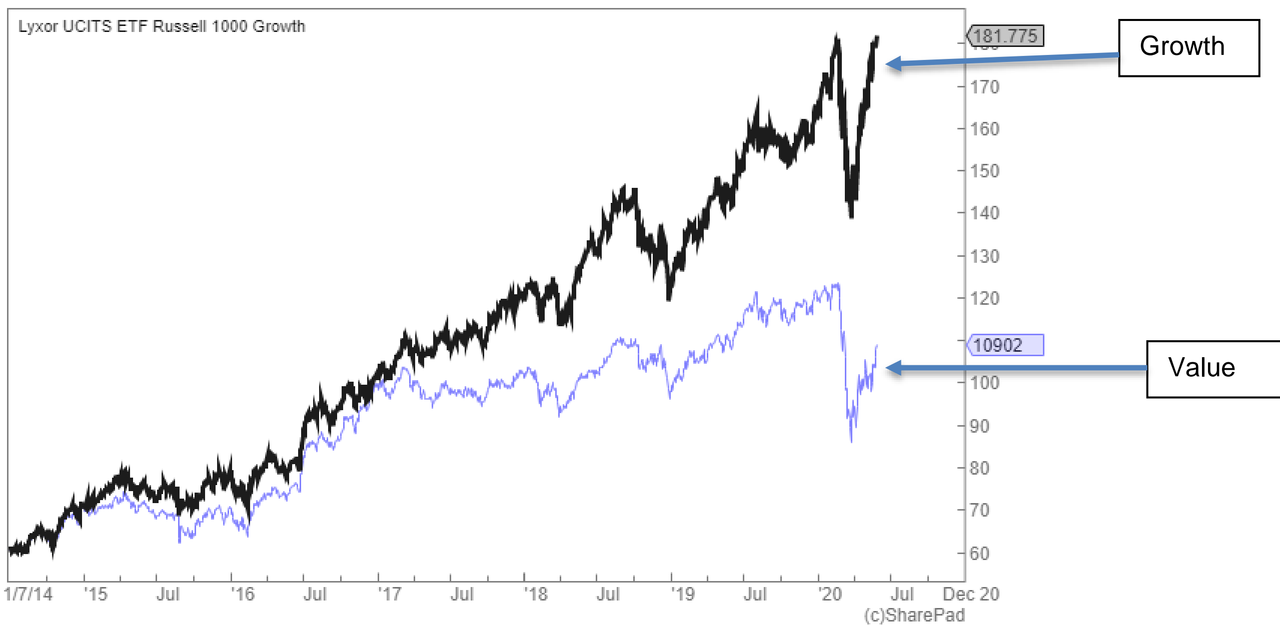
Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

Dash to Trash

1 June 2020

Every bone in my body wants to believe this is the canary in the coal mine. That wonderful feeling when after a long and very bumpy flight we place our feet safely on home turf. It felt like that as we had a growth wobble last week. The US technology unicorns have by and large bypassed the market volatility and continued to new highs until last week they faltered while value stocks saw significant moves up. This SharePad chart illustrates the frustrations of value investors over the last 6 years where an investment in a Russell Growth index outperforms the Russell value index ETF by 67%.



The picture is more extreme over a longer time period. This MSCI All World Growth vs Value chart illustrates that the dot com bubble was a mere foothill compared to today:

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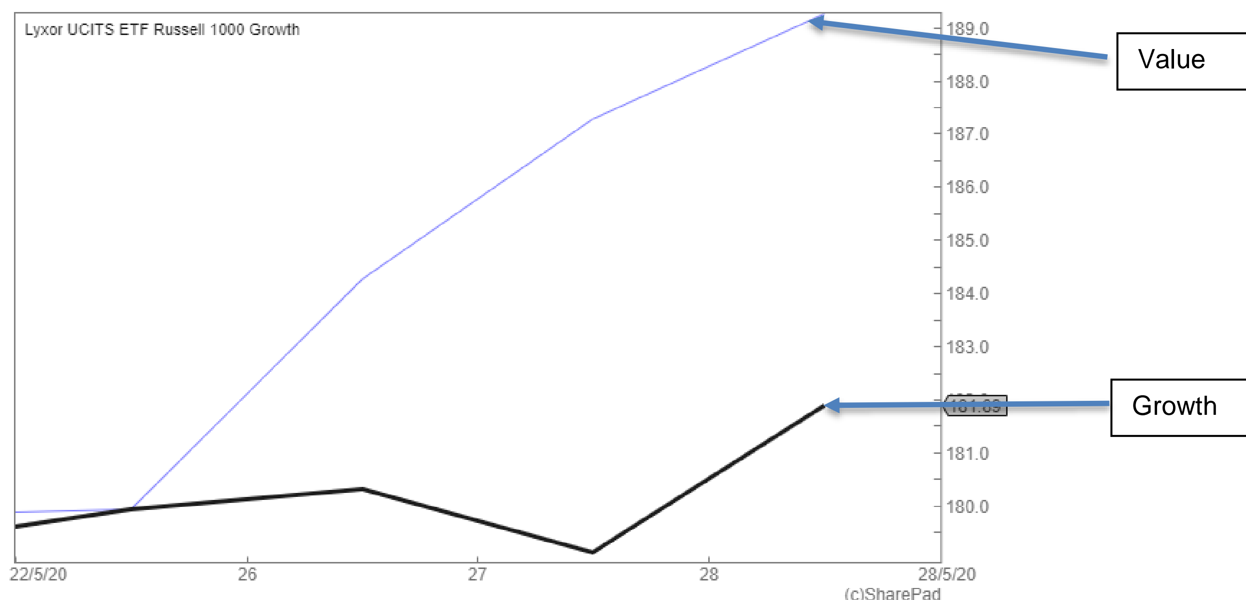
And yet in the last week the outperformance of value over growth has been marked. I am hoping this is the canary in the coal mine forewarning of the return of value so I can return to my comfort zone. But I could be wrong.



Value vs Growth

Value stocks by definition are risky, so in times of uncertainty growth stocks look safer so whilst value stocks look cheap that doesn't stop them underperforming in a downturn. In market terminology that is the "flight to safety" phase of a market cycle. It is this same motive that led us to stock pile toilet paper as fears of lockdown permeated our minds that leaves value stocks, which appear to have a problem, unloved at times of risk while the safety of growth stocks remains appealing. This is part of the reason that Fundsmith, Lindsell Train etc have outperformed the recent bear market with their collection of large quality stocks.

A resurgence of value stocks implies optimism for our economic prospects. Value stocks start to appear less risky resulting in the valuation discount unwinding while the outlook for growth stocks continues to be positive. For this reason, the best times for value stocks is as we come out of a downturn.

Anecdotal evidence It was the 20% rise in International Personal Finance on Wednesday for no apparent reason that caught my attention. This is one of the riskiest stocks I follow as the outcome of actions by Polish, Hungarian, Romanian and Czech governments and regulators attempting to impose debt repayment moratoria and rate caps is unknowable. There are other anecdotal signs that value is set to outperform, such as newspaper headlines from a week ago suggesting that value investing is over. Only when everyone has given up do things finally turn. According to Warren Buffett a climate of fear is an investors friend.

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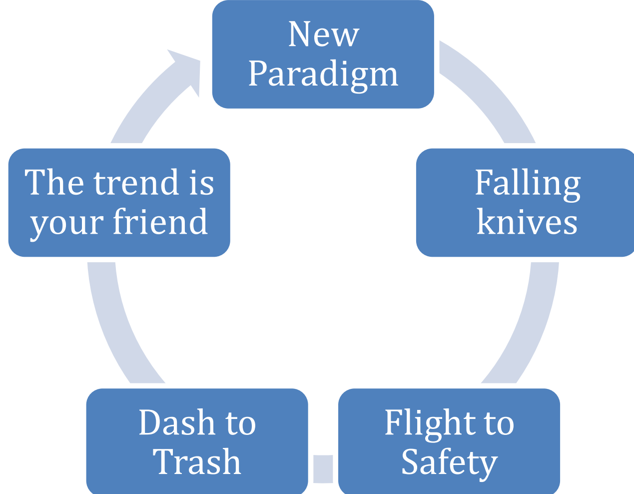
Money

Could this be the death of Buffett-style investin

Scottish Mortgage Investment Trust is now the 38thg largest FTSE 100 constituent and has Tesla as its largest holding accounting for 11% of the NAV while it also counts Amazon, Netflix, and Alibaba among its top 10 holdings. Last week it rose a modest 1% while it has close to 10% gearing and trades at a 3-4% premium to NAV. Another similar fund, the Baillie Gifford American fund run by the same fund manager, Tom Slater, is also full of growth stocks and was down 1% last week, indicating the possibility that value is becoming more important than the fervour for the large US growth stocks. With the gearing and the premium valuation of these funds it appears to me there is significant risks in these funds. Perhaps more risk than some of the neglected value stocks.

Long term of short-term change? By definition, for market events to recur the previous generation that experienced mistakes of previous exuberance must be largely gone. And we now have a 30-year period when growth has generally outperformed value. 30 years ago newbies to the stock markets were taught the benefits of value investing by the previous generation of investors. Today it seems to me that the great fund managers are teaching us the benefits of compounding, which naturally biases towards growth stocks. The phrase “when you see a band wagon it’s too late” comes to mind. With the growth bandwagon in full steam I find myself wondering if we may have a 30 year return to value investing? I have no idea whether that will be the case just now, but I do believe this is one of those times in the cycle when value stocks outperform. I am seeing all the evidence of a dash to trash.

Sometimes I find it helpful to look at cycles through the window of the washing cycle below. Markets are like a washing machine which can travel at different speeds. In 2008 it was slow while this time it feels rather like the spin cycle.



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Value

Value stocks include a lot of banks which have apparently been encouraged to lend money by governments printing money over the last 10 years while at the same time changes to capital requirements have ensured they hang on to the money rather than lend it out. Introductions of bank taxes and fines have further hindered the large banks with the effect that there are 5 remaining banks in the FTSE 100 today whose share prices have declined between 45% and 75% over the last 10 years. And yet last week they have moved up strongly.

No.	Name	Price	%chg 1w
1	Barclays PLC	120.62p	▲16.1
2	HSBC Holdings PLC	$24.175	▼-0.902
3	Lloyds Banking Group PLC	31.085p	▲9.49
4	Royal Bank of Scotland Group PLC	117.45p	▲13.8
5	Standard Chartered PLC	388.7p	▼-0.715

At times of low interest rates banks struggle to make money as the interest margin between what they can borrow at and what they can lend at gets squeezed. At times of economic recovery expectations for future interest rate rises accelerate making banks strong performers at times of economic recovery.

How cheap are the banks?

Having spent the last 10 years since the credit crunch building up their capital base the banks are now well capitalised and, should rates start to increase in an economic expansion, they are well placed this time to lend money. I suspect therefore a good way to look at the large banks now would be to subtract their excess capital from the market cap to see what value the market is attributing to the existing business. In order to do this, is may be necessary to describe what a CET1 ratio is.

CET 1 ratios. Banks use mnemonics liberally. The CET1 ratio stands for "Common Equity Tier 1". This is similar to equity divided by gross assets which is the inverse of gearing in English. So, a high CET1 ratio means a lowly geared balance sheet and conversely a low CET1 ratio is a highly geared balance sheet. Regulators like to make lots of adjustments, so the equity is adjusted to include instruments that can be converted to equity thus it is a little wider while the net assets are adjusted downwards to what banks call "risk weighted assets". The net assets available such as loan books are generally reduced to ensure prudence for the CET1 ratio. But to a casual observer a ratio of 5% would equate to a 20X gearing ratio of adjusted gross assets to adjusted equity, and a 10% CET1 ratio is implying 10X gearing of assets to equity.

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Excess Capital

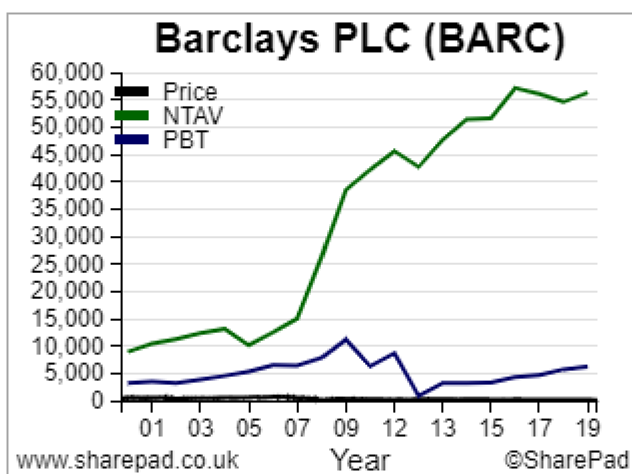
The banks generally have excess capital which is earning low returns causing them to become value investments. The table below compares the current CET1 ratio to the minimum requirement. The difference is % excess capital. This is then translated £ of excess capital by multiplying the excess capital % to the risk weighted assets. If we then subtract that from the market cap of the business, we can get an idea of what value the market is attributing to the underlying business. In an economic upturn this underlying business is likely to experience increasing profits.

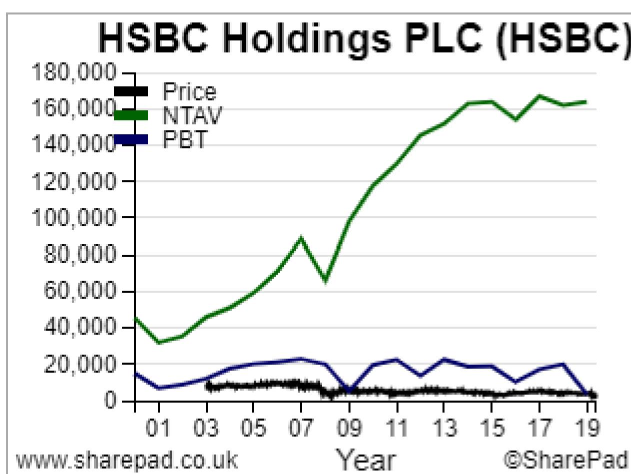
	CET1 %	Requirement %	Excess %	Risk Weighted assets £bn	Excess £bn	Mkt Cap £bn	Business value £bn
Barclays	13.10%	11.50%	1.60%	77.7	1.24	21.5	20.3
HSBC*	14.60%	6.10%	8.50%	857.1	72.85	97.8	24.9
Lloyds	14.20%	4.50%	9.70%	209	20.27	22.5	2.2
RBoS	16.20%	8%	8.20%	185	15.17	14.5	-0.7
Std. Chtd.	13.40%	10.00%	3.40%	221.13	7.51	12.6	5.1

**HSBC shown in $*

This table is suggesting that the market attributes close to no value at all to the underlying business of both Lloyds Bank and Royal Bank of Scotland.

Over the last 20 years these banks have very successfully grown NAV while PBT has grown modestly with the exception of the credit crunch and share prices have generally declined. This can be evidenced from Sharepad's useful financial charts:





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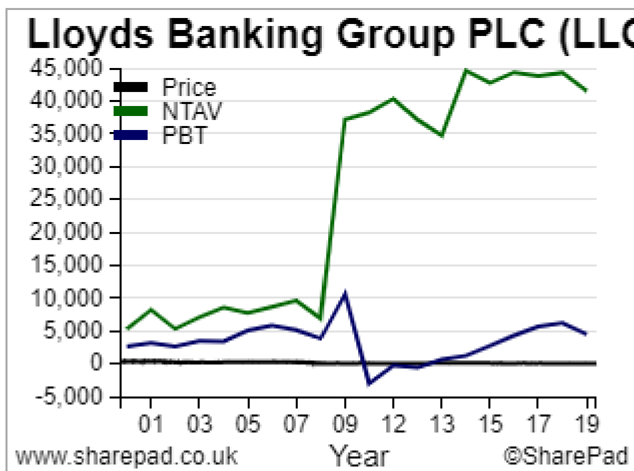

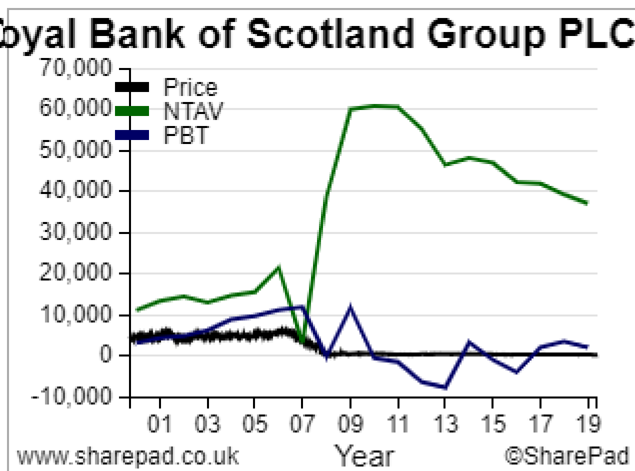

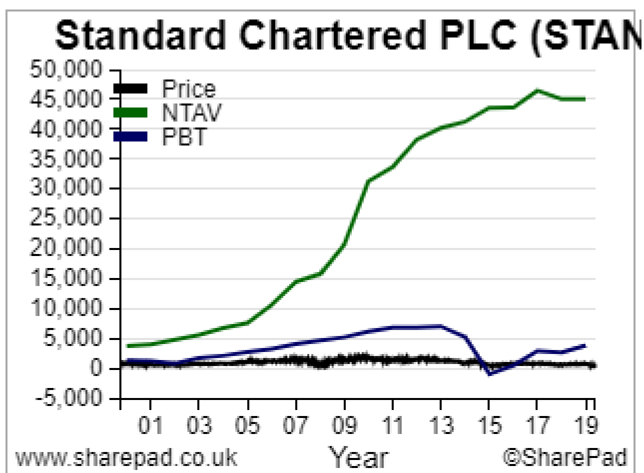

These charts go some way to answering the question of why all that quantitative easing from the government hasn't found its way into the economy. Because its here in the NTAV of the banks, instead of being lent out. And now with COVID 19 we have more of it coming. And the banks have now built up large amounts of excess capital. Imagine what sort of economic boom there might be if they actually started lending it. Jeremy Hosking, an ex-founder of Marathon Asset Management asked last week whether Lloyds was "a for profit private company or simply a publicly owned utility" and there was a useful article on the subject in The Sunday Times by Oliver Shah this weekend. It may be that we are nearing a time of change.

Valuations

Price to Book Value: The banks have been earning poor returns on all those net assets they have been accumulating over recent years. This isn't due to impairments but in fact due to low interest rates. If this were to increase this would directly impact profitability. The reason the banks trade at a discount to net assets is that they are earning very low returns on net assets (ROE). Shown below

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Name	Price	Return on Equity	Price to NAV	PE	Yield
Barclays PLC	124.03p	6.6	0.3	4.9	2.5
HSBC Holdings PLC	$24.175	4.3	2.7	204.9	6.2
Lloyds Banking Group PLC	31.795p	6.1	0.5	9.1	3.5
Royal Bank of Scotland Group PLC	119.75p	3.4	0.3	12.9	1.7
Standard Chartered PLC	399.9p	4.9	0.3	6.7	1.4

All the banks are profitable. The banks with higher PE's have lower ROE's indicating the share prices may be anticipating improving returns, while those with the lower PE have the higher (albeit unsustainably low) ROE suggesting that little is priced in by way of improvement.

Yield: It is noticeable that all the banks say they have cancelled their dividends at the request of the PRA, their regulator. Because with these strong balance sheets they could probably afford to be paying dividends. The table above shows last year's dividend yield which in my view may be a better guide to the future than the current year.

M&A Potential?

When companies trade below tangible book value, they frequently become acquisition targets and the lack of M&A activity amongst the banks seems strange. In recent years according to Dealogic bank merger and acquisition activity has accounted for 2.5% of global M&A activity which is down from 14% a decade ago. There has been defensive M&A such as when Clydesdale & Yorkshire Bank took over Virgin Money a year ago in a crowded challenger bank space. Meanwhile M&A in the payments space is frenzied as the payment networks and digital bank providers conduct an arms race to become the new challengers. This leaves the traditional banks facing threats from many fronts and consolidation could create shareholder value with their swollen balance sheets.

This opportunity was spotted by activist investor Edward Bramson who took a 5% stake in Barclays in 2018. Bramson operates through an investment vehicle called Sherborne investors and has a 100% track record of creating value by shaking up companies. Past successes include 3i, Electra Private Equity, Spirent, Elementis and F&C Asset Management. Barclays is his biggest bet yet and having been defeated in his bid for a board seat he continues to hold a 5% stake in the company. In 2018 Barclays was said to be in discussion with Standard Chartered bank regarding a merger and Bramson has been pressurising Barclays to divest or close its investment bank. After failing to gain a board seat in 2019 there has been a period of quiet but in February this year Bramson renewed his attacks on Barclays, requesting a meeting with the chairman. In 2019 the corporate investment bank at Barclays achieved a 3.9% ROE using £25.8bn of equity, which is 24% of the market cap of the company.

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Conclusion

I am tempted by the excess capital of both Lloyds and Royal Bank of Scotland. The market is attributing almost no value to the business excluding the surplus capital. While we may not like these value investments Lloyds has produced £4.4bn to £6bn profit in each of the last 3 years, while RBoS has produced between £2.2bn and £4.2bn. Its always nice to buy profitable businesses effectively for nothing. If I was forced to choose between the two, I would go for Lloyds, largely on the basis that I would be owning these for reasons to do with the macro environment and the higher ROE and higher PE is indicating there is less stock specific risk involved. Meanwhile Barclays' battles could act as a catalyst for renewed consolidation in the space.

Summary

I would like it if this was a long-term reversion to value investing but that may be wishful thinking. Certainly, this looks like the stage of the cycle when the power of risk valuations unwinding is greater than the power of growth - known politely as the dash to trash, and less politely as the flight to shite. In this environment the large banks are a good way to play this and both Lloyds and RBoS look well placed to benefit. While Barclays activist has the potential to re-ignite consolidation activity within the sector. For those that prefer a more stock specific small cap risk there is a smorgasbord of choices, such as Non-Standard Finance, Ince Group and IPF to name but a few.

Forthcoming Events

Company	Date	Event
Ince Group	25-Jul-20	FY Results
IPF	29-Jul-20	H1 Results
Lloyds	30-Jul-20	H1 Results
Std. Chartered	30-Jul-20	H1 Results
Barclays	31-Jul-20	H1 Results
RBoS	31-Jul-20	H1 Results
HSBC	03-Aug-20	H1 Results

Source: SharePad estimates, Company website