Investment Insight

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ARIA | CAPITAL

Reasons why: *Following the fall out of the financial crisis, investors have been slow to recommit to investing in companies in the financial sector. Understandably so.*

Quite contrary to this sentiment, Alex Wright of Fidelity, a highly regarded contrarian investor, is firmly in the other camp. He understands the reticence of investors to consider the sector more aggressively, but he fundamentally disagrees with the cautious approach being adopted.

We have invested very successfully in several of Alex's funds for many years and we know that his views always warrant consideration. Therefore, in this week's ***Inside Track*** *we pause to consider the rationale supporting his bullish view on financials.*

Nucleosynthesis: *As any leaving cert chemistry student will tell you, gold is a chemical element with symbol Au and atomic number 79, thought to have been produced in supernova nucleosynthesis, from the collision of neutron stars. Gold is resistant to most acids, though it does dissolve in aqua regia, a mixture of nitric acid and hydrochloric acid, which forms a soluble tetrachloroaurate anion.*

Gold, however, has properties other than purely physical, having often been implemented as a monetary policy via a gold standard, and being used by investors as a form of protection against stock market shocks. How effective has it been during such periods? This week's ***Pic of the Week*** *takes a closer look.*

Quoted...

"It's clearly a budget. It's got a lot of numbers in it" — George W. Bush

The Inside Track

Alex Wright, fund manager of the Fidelity Special Situations Fund, believes that investors are not fully recognising the considerable changes that have occurred inside banks and in the external operating environment. The following are some of his recent views on the matter.

There has been little growth for 10 years (except in compliance!)

Growing companies are rewarded by the market with high valuations, creating expectations that ambitious management teams aim to meet or exceed, which in turn can lead to excessive risk-taking...All stakeholders now seem to except that banking is a low growth industry, and the best we can hope for as shareholders is a respectable dividend yield at some point. This helps to give me confidence that the loans written by banks in the last decade are much less risky than those written before the crisis. Corporate culture in banks no longer places growth on a pedestal above all else. Instead, there is an increased focus on caution and stability.

Instead of investing for growth, banks have spent the last 10 years building up capital reserves

...UK banks' balance sheets have doubled in strength since the financial crisis. Tier 1 capital consists of common stock and cash reserves, and is a measure of a bank's capacity to absorb shocks...Since the crisis, regulators have required banks to use their profits to bolster reserves rather than reinvest into growth projects or pay dividends...Dividends and share buybacks should now be supported for years to come, creating a degree of downside protection.

For example, in the case of Lloyds, which has increased its capital ratio from 8% in 2009 to 13% today, we expect the stock to yield as much as 8% this year. Citigroup, my largest position in the sector, has recently received approval from the SEC to buy back of around a third of its current market capitalisation over the next three years. I do not believe the market has fully recognised the significance of these powerful signals from conservative regulators.

In a severe recession, I would not expect banks to outperform. But history tells us that recessions and bear markets are only very rarely accompanied by banking crises and capital destruction on the scale of 2008. With stronger balance sheets, UK banks are well positioned to weather the next recession, if and when it comes.

Funding models are now more self-sustaining

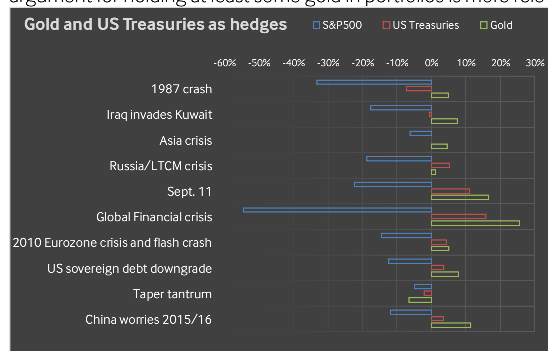
Over the last decade, one of the biggest changes to the operating models of banks has been a significant reduction in usage of wholesale funding, and an increase in deposits...Most banks in the UK now cover most of their lending with deposits from customers rather than borrowings from other banks. In theory, this should make the system much more stable and less prone to a liquidity shock.

Optionality from interest rate rises

To make profits, banks need to be able to write long-term loans to borrowers at higher rates than they borrow short-term money from depositors or other banks. Therefore, the flat and low yield curve of recent years, created by central banks, has constrained profitability across the whole sector. A gently rising long-term bond yield curve is enormously helpful for net interest margins and banking profitability, even as it is negative for the justified valuation of the so called 'defensive growth' sectors that have led the re-rating market higher. I do not know what the future path of interest rates will be. But I do know that most investors are positioned for the 'lower for longer' world, and not expecting banking profits to be boosted by a rise in rates. The market is currently offering you a free option on this possibility. However, as the value of this option is contingent on a single macroeconomic variable which is subject to great uncertainty, I would only call it half a reason to hold shares in banks, rather than a full one!

Pic of the Week

The following chart shows how the price of gold has performed during various stock market sell-offs over the last 30 years. The level of protection provided is material, although the bond market is not too far behind as we can see from the performance of US Treasuries. With many of the traditional safe-havens such as government bonds trading at historically high levels, perhaps the argument for holding at least some gold in portfolios is more relevant now.



Market View

	Last 7 days	Last 12 mths	YTD	5Y Ann.
Global equities	+0.3%	+18.4%	+13.6%	+10.4%
US equities	+0.1%	+19.4%	+14.1%	+12.3%
European equities	-0.2%	+15.0%	+7.5%	+7.2%
EM equities	+1.3%	+23.8%	+29.6%	+2.3%
Irish equities	-1.2%	+17.0%	+4.7%	+16.0%
Commodities	+0.8%	+3.0%	-2.6%	-10.3%
Hedge funds	-0.1%	+5.9%	+4.8%	+2.1%

Economic indicators	*Bond yields*	*Inflation*	*GDP YoY*
Ireland	+0.7%	+0.2%	+5.8%
Germany	+0.4%	+1.8%	+2.1%
USA	+2.3%	+1.9%	+2.2%
China	+3.7%	+1.8%	+6.9%

Week ahead: Key events

16/10 Japan Industrial Production & Retail Sales
16/10 US Manufacturing
17/10 UK House Prices & Inflation Data
17/10 Eurozone CPI & Germany Economic Sentiment Data
17/10 US Retail Sales & Housing market Index
18/10 UK Unemployment & Eurostat Construction
18/10 US Mortgage Applications & Housing Starts
19/10 UK Retail Sales & US Leading Indicators
20/10 ECB Euro Area Balance of Payments

Currencies	*Current*	*YTD Δ*
EUR:USD	1.18	+12.6%
EUR:GBP	0.90	+4.9%
EUR:CNY	7.80	+6.3%
GBP:USD	1.32	+7.2%
Bitcoin	5,298.63	+456.6%

Commodities	*Current*	*YTD Δ*
Gold	1,293.14	+12.2%
Copper	6,756.00	+22.3%
Oil	56.48	-3.8%
Wheat	433.75	-6.7%

Central Bank rates	*Current*
Eurozone	0.00%
USA	1.25%
UK	0.25%

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