# GLOBAL BANKS – WHERE WE STAND



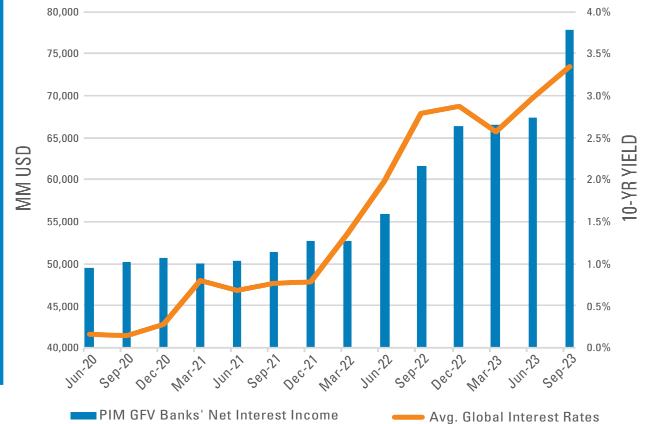
Our Global Focused Value strategy currently has a weighting of approximately 26% in financials overall. Nearly 40% of that exposure is invested in diversified financials not defined as banks by GICS, including insurers, asset/wealth managers and other financial institutions. The remaining 60% of our financials exposure is in banks, which–at 7.5x forward earnings–are currently the cheapest industry in the MSCI AC World Index, trading at roughly a 50% discount to the market.[1] We believe this valuation is unwarranted; to explain where we stand, it's worth reviewing how we arrived here.

**Exhibit 1**
**MSCI ACWI BANKS - PRICE TO EARNINGS (NTM)**

*Source: FactSet, Pzena analysis*

Banks hit a sweet spot during the 2021/22 post-pandemic rebound. Economic activity picked up, boosting loan demand, while long-term interest rates started rising with inflation, resulting in wider net interest spreads. Many lenders posted record net interest income (NII) in FY22, while investment banking and trading revenue surged due to a flurry of capital markets activity.

**Exhibit 2**
**RISING NET INTEREST INCOME**



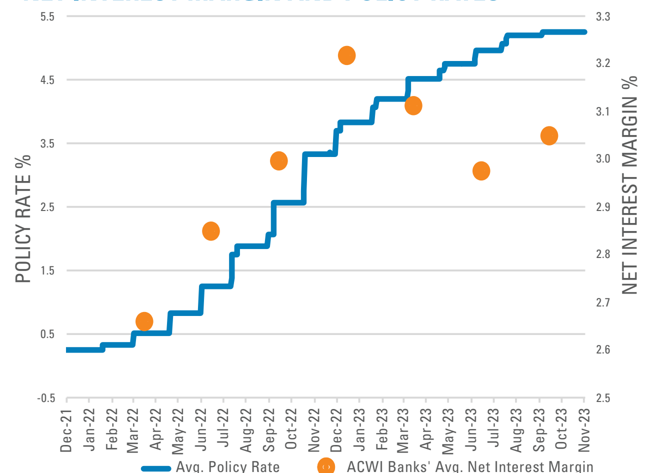

*Source: FactSet, Pzena analysis*

*Simple average of Euro, UK, US, Japan, and Hong Kong 10-year benchmark bond yields*

*Bank stocks held in our Global Focused Value (GFV) strategy as of 9/30/2023. Includes Wells Fargo, Citigroup, ING Groep, HSBC, Resona, BofA, Barclays, NatWest Group, Shinhan Financial, and Standard Chartered; aggregate NII in USD*

Sentiment began to shift, souring throughout 2022. Central bankers rapidly tightened monetary policy to combat inflation, prompting a rise in short-term interest rates, i.e., higher funding costs for consumer/commercial banks. It took time for this to impact banks' profitability, as deposits proved to be remarkably sticky, but net interest margins (NIM) eventually started to level off.

**Exhibit 3**
**NET INTEREST MARGIN AND POLICY RATES**



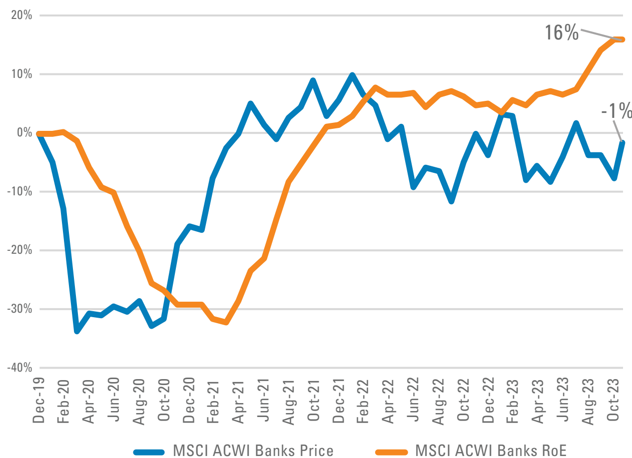

**Simple average of ECB, BoE, US Fed., and Hong Kong policy rates; simple average of banks' NIMs*

*Source: FactSet, Pzena analysis*

[1] *Source: FactSet*

Despite the rise of deposit betas, which was to be expected given the rate environment, banks were still generating their highest returns on capital in the post-GFC era, while credit remained benign. Investors' moods shifted abruptly in early 2023 when the regional banking crisis unfolded in the US – events we assessed to have little to no bearing on our global value portfolio's bank holdings. Shares sold off nonetheless, and the industry has essentially traded sideways ever since. Indeed, returns on equity (ROE) are up 16% from pre-pandemic levels, while shares are effectively flat.

### Exhibit 4
**CUMULATIVE % CHANGE IN SHARE PRICE VS. RoE**




*Source: FactSet*

Investors are now predominantly concerned about 1) continued and persistent net interest margin (NIM) pressure, 2) an end to the current credit cycle, which would mean higher default rates, and 3) the uncertainty around proposed legislation – specifically Basel III endgame.

Barring a severe global recession, banks' core lending operations should remain highly profitable regardless of the future direction of interest rates. Our banks' earnings are up materially from pre-pandemic levels, while their loan books have shrunk. None of our banks are currently observing material adverse credit developments, even via their early detection systems, but higher earnings on smaller balance sheets allows for more loss-absorbing capacity should asset quality decline.

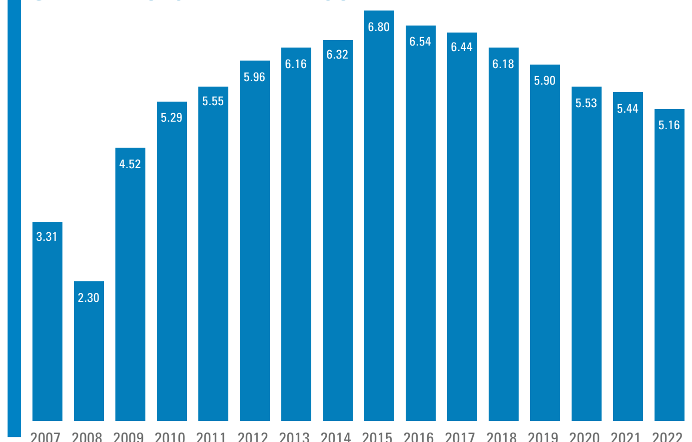
### Exhibit 5
**GFV BANKS - NET INCOME VS. LOAN GROWTH**

**Bank stocks held in our Global Focused Value (GFV) strategy as of 9/30/2023. Includes Wells Fargo, Citigroup, ING Groep, HSBC, Resona, BofA, Barclays, NatWest, Shinhan, and Standard Chartered. Aggregate NI and loan growth in USD.*

*Source: FactSet*

Even if macro conditions deteriorate, and credit quality consequently worsens, the banks in our portfolio are extremely well capitalized and more than adequately provisioned for rising defaults/non-performing loan (NPL) formation, having built up significant buffers in accordance with post-Global Financial Crisis (GFC) regulations. In fact, capital positions are materially stronger today than at the end of 2007, just before the GFC. Common Equity Tier 1 (CET1) ratios are also higher today than in 2019, just before the COVID-19 economic shock (CET1 data isn't available before 2014, and thus, not comparable to the GFC era).

### Exhibit 6
**GFV BANKS' CAPITAL RATIOS**




**Capital ratio is calculated as the simple average of tangible common equity / tangible assets (excluding Resona due to unavailable data)*

*Bank stocks held in our Global Focused Value (GFV) strategy as of 9/30/2023.*

*Source: FactSet*

While we are cognizant of certain risks, including potential future regulation, global banks' NTM forward multiple of 7.5x falls within the first percentile of monthly data going back 20 years. Relative to the market, the industry has rarely been cheaper over the past 20 years. Our specific holdings are trading at 6.8x FY24 earnings, on average, compared to a multiple of 15.6x for the broad index[2].

**Exhibit 7**

**MSCI ACWI BANKS - DISCOUNT TO THE MARKET**

*Source: FactSet, Pzena analysis*

Each of our 10 bank holdings have idiosyncratic catalysts that we believe will lead to a re-rating of their share prices. Both Citigroup and HSBC – trading at double-digit earnings yields and below the net value of their assets – have material cost opportunities available, with the former in the midst of a major restructuring. We believe regulatory risk is priced into Wells Fargo shares, as management awaits the lifting of the Fed-mandated asset cap; in the interim, the bank is generating a 14% return on tangible equity (RoTE) and buying back stock. Growing excess capital positions at ING and NatWest portend well for future shareholder returns, while UK lender Barclays should benefit from an anticipated rebound in investment banking activity. Despite near-term earnings pressure, our banks broadly remain overcapitalized, as evidenced by an expected total yield (buybacks + dividends) north of 10% from FY23-25. With our Global Focused Value banks trading at just 76% of their tangible book values and 5x our estimate of their normal earnings power, we believe the inherent risks are largely priced into the stocks.

Our non-bank financial positions have similarly strong investment cases. One of the most compelling is Swiss wealth management giant UBS, given its valuation assumes little to no value accretion from the Credit Suisse acquisition. In our view, while the integration of Credit Suisse will be a long and complex process, the earnings upside is substantial, even considering the inherent execution risk. Life insurers Equitable Holdings and MetLife have been unduly punished due to their commercial real estate exposures, which we believe are of much higher quality than investors assume. Given the material earnings tailwind from higher interest rates – a decade in the making – and improving mortality trends, we believe both insurers are poised to outperform. European asset manager Amundi, which has a best-in-class distribution network, continues to take market share in the current environment despite having been impacted by weak market conditions and asset flows in Europe, which are not expected to persist. Meanwhile, Capital One, which is more exposed to subprime borrowers, is trading at approximately 4.2x our estimate of normal earnings, largely due to concerns over credit quality, which we believe to be unwarranted given normal levels of charge-offs and management's commentary that credit conditions are stable.

While global financial institutions certainly face a host of macroeconomic challenges, we don't believe the broad sector should be trading near GFC/European sovereign debt crisis/COVID-19 levels. Specifically, we maintain high conviction in our financial holdings, which are diversified, extremely well capitalized, and trading at a 15% forward earnings yield today.[3]

[2] *Source: FactSet*

[3] *Source: FactSet*

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