CREDO

Dancing on ice

My first analyst job was part of a team of a dozen or so 20 to 30 years of age “generalists” who covered multiple sectors. The sole outlier was the Financials guy, who was much older, wiser and sat in the corner of the office - detached from the rest of us. This depiction is not unusual. A recent colleague came from a similar setup - all generalists but for their Financials guy. The story goes that when his colleague downloaded the data from his terminal into his Excel models the lights in the building started to flicker.

Financials is a tough sector for fund managers. It is relatively small, comprising only ~12% of the S&P 500 Index. Banks and insurers represent only ~4% and ~3% respectively. Then there are the accounting, financial modelling and performance metrics which are completely different. As such, they tend to be least understood, and often shunned by managers who (typically) cut their teeth elsewhere.

Financials were a hot sector in the years preceding the 2007 Global Financial Crisis (GFC). The economy seemed strong (albeit superficially), banks’ loan loss provisions were low, and the insurance industry was benefiting from hardening pricing. Meanwhile the Federal Reserve had been raising interest rates, buoying investment income for insurers and net interest margins for banks.

Beneath the surface though, the banking sector had weak foundations. Lending standards in the housing sector had become lax. Banks obfuscated the risks and transferred them off balance sheet to “bag holders” around the world – repackaging their junk loans as AAA-rated bonds. Chuck Prince, the CEO of Citigroup, famously commented in July 2007 that “as long as the music is playing, you got to get up and dance”. Less than three months later, Citi would have gone bankrupt - but for a bail-out by the US government. One benefit of the GFC was that it clearly unmasked the good and bad operators. As Mr Buffet once opined, it is only when the tide recedes that you can see who is swimming naked. Better managed banks such as JP Morgan, Wells Fargo and PNC fared relatively well. In the immediate aftermath, banks were considered un-investable and verboten. Over the next decade, the sector would be slowly suffocated by low interest rates, regulatory burdens and leverage restrictions.

Though the Property and Casualty (P&C) insurance sector fared well during the GFC, the sector also suffered through the decade of financial repression, which reduced investment income from which it previously derived a sizeable amount of its earnings. To make matters worse, underwriting became much more competitive, as excess capital entered the sector from yield-starved investors (e.g. insurance linked securities). Banks, up to their old tricks again, repackaged these high-yielding bombs as catastrophe bonds. The benefit of this slow death by a thousand cuts decade was that it separated the wheat from the chaff.

This year, we have been overweight P&C insurers and (to a lesser extent) banks, which has driven much of our outperformance. Our view was that these sectors had been unloved for so long and as a result valuations were cheap. Meanwhile, the earnings outlook was almost uniquely optimistic in a higher rate environment, benefiting from higher interest income in contrast to the rest of the market, where interest is an expense. Insurers are simultaneously benefiting from a hardening market after years of elevated (Covid-19 and catastrophe-related) claims. With interest rates languishing below zero and inflation fast accelerating, the risk-reward seemed asymmetrically skewed to the upside.

Given our experience during the GFC, more than any other, Financials are a sector where we place great emphasis on the long-term track record of the company navigating previous cycles, generating superior returns on equity, growing book value per share through the cycle and paying a dividend yield.

My second analyst role was part of a three-man investment team covering all sectors, including Financials. The erstwhile portfolio manager concentrated more on sector positioning - in addition to single stocks. Often bottom-up analysts lose sight of the big picture and cannot see the wood for the trees. He focused on business cycles, mean reversion and tended to be contrarian - though not for the sake of it. More like Wayne Gretzky skating to where the puck is going, not where it has been – his focus was on the medium-term beyond the horizon of sell-side cheerleaders.

While working there, I learned that cycles don't last forever. This one will turn eventually like all cycles do. Today, Financials valuation multiples have rerated somewhat, though sentiment is not exuberant. Therefore, we believe there remains runway for relative rerating to continue. Meanwhile (stale) earnings estimates continue to be upgraded. Having said that, we are pragmatic, conscious that sector share prices have historically peaked before earnings and any interest rate "pivot". The late John Templeton had an adage that "bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria". As ever, we remain vigilant, monitoring both "bottom up" prospective returns achievable over the medium-term as well as "top down" sentiment and macroeconomic data. As we have been maximum overweight Financials this year, you can expect us to slowly trim this down over the coming months. Unlike Chuck, don't expect us to stay for the last dance. ■

Important notice