CREDO WEALTH

A feast of change

There have been slim pickings for investors looking for good news on Wells Fargo (Wells) in recent years. The unveiling in September 2016 of millions of unauthorised accounts, opened as a result of aggressive sales practices, has been compounded by further revelations of malpractice across various divisions.

Upon the exposure of the initial issues, Wells agreed a settlement with the Consumer Financial Protection Bureau, instigated training programs, monitoring processes and internal controls. Unfortunately, as details emerged of further problems in various other divisions, the political fallout has escalated. Multiple investigations have been launched, various settlements and fines have been paid, which although immaterial relative to the market value of the company, have created negative sentiment. Two CEOs have resigned shortly after testifying in front of Congress. In 2017, in an unprecedented move the Federal Reserve, for the first time, imposed a cap on the entire assets of the bank. The asset cap will be in place until the company has shown sufficient progress in improving its operational risk management and oversight. The result is that growth has been restricted.

At the same time as Wells has been struggling, other US banks have benefited from higher interest rates, lower credit spreads and mark-ups on securities portfolios. Wells does not benefit to the same extent from these exposures, a benefit during the financial crisis but a disadvantage during the recent bull market. The outcome is that Wells has gone from trading at a premium to peers, to trading at a significant discount.

Despite its problems, Wells' long-term financial track record remains stellar. Returns on both equity and assets are industry leading through the cycle and the company's balance sheet is rock-solid. Wells has never cut its dividend (not even during the global financial crisis) which, at circa 4%, remains attractive. In addition, the company has been able to use its excess capital to buy back a significant amount of stock, reducing its outstanding share count by almost 10% per annum.

Moreover, there remains a lot that can go right for this company. In September 2019, Wells announced the appointment of a new CEO having been under temporary leadership since March. Charles Scharf has been CEO at BNY Mellon, Visa, Retail Financial Services at JP Morgan and the retail division of Bank One. He has a history of enacting change, focusing on cost-cutting and is a familiar name on Wall Street. Mr Scharf's first task will be to address the concerns of regulators and execute the changes required in order to get the asset cap lifted, which we believe should happen next year. This would allow Wells to deploy more capital into the business, allowing revenue and earnings growth.

There are also significant opportunities on the cost side. Wells has a cost to income ratio which is much higher than peers of a similar size and scale. Due to the problems of recent years, the bank is currently carrying heavy legal and compliance costs. As these issues are resolved, the associated expenses should reduce over time. In addition, there is the potential for Mr Scharf to implement a cost cutting program to further improve the efficiency and so boost earnings.

The options are bountiful but execution is needed. However, due to the low sentiment surrounding the stock, we believe that small wins could start to drive a re-rating of the shares. The positive price reaction to the news of Mr Scharf's appointment is evidence of this.

As shareholders, we have been through a period of more famine than feast when it comes to Wells. However, with a new, external CEO in place, we believe that the pieces are in place for a change in fortune. In the meantime, we continue to be served a good dividend every year, added to by share buybacks. We wait to reap the rewards of our patience.

Important notice