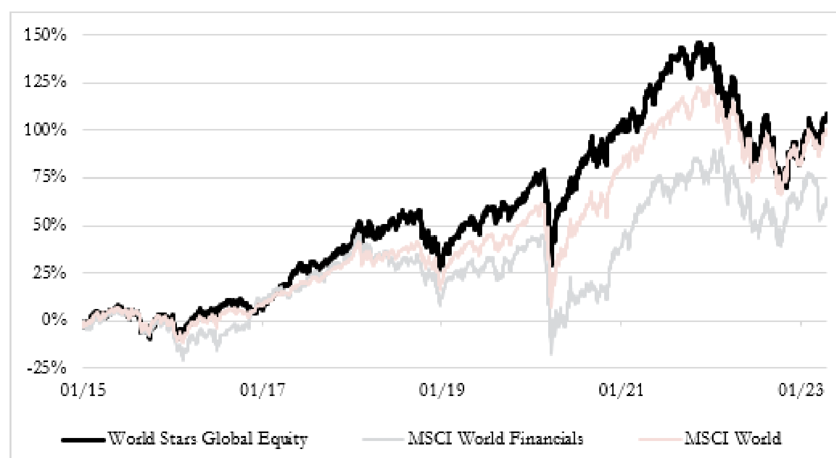
Investment Insight

THE TROUBLE WITH INVESTING IN BANK STOCKS

We invest on the basis of fundamental research in companies that offer quality and value over the long-term. Our four criteria for quality are a strong and sustainable competitive position, in a good and growing market, a management team with a record of value creation and a balance sheet so strong as to weather any kind of adversity. These criteria take us into companies that are involved in digital transformation, consumer products, healthcare and life sciences, and industrials. They take us away from capital and resource-intensive companies, balance sheet-driven financials and regulated businesses that rely on governments, licenses or concessions for their returns.



Source: Bloomberg, SS&C Technologies as at 14.04.2023

Our World Stars Global Equity fund did somewhat worse than the market last year because we do not own energy companies or banks. This year our fund is doing a lot better. Why didn't we invest in bank stocks?

We invest in companies not markets and we look for companies that are resilient in the face of macro-economic challenges. Banks are highly exposed to both, which makes it hard for us to look at them as long-term investments.

There are three key reasons why banks struggle to fulfil our criteria: First, they are difficult for outsiders to analyze. As we have just seen again in the case of Silicon Valley Bank, First Republic or Credit Suisse, it is impossible to know what the assets or liabilities are given the complexity of the businesses. Second, the balance sheet of any bank is inherently unstable because a bank's core business is maturity transformation, taking in short-term deposits and using them to make loans that are often not repaid for years. This means that any bank, no matter how large, is potentially vulnerable to a sudden outflow of short-term deposits. Third, one of the few certainties is that regulators want to increase the amount of equity required to support the assets on any bank's balance sheet. Therefore the return on equity (ROE) of a bank is highly leveraged and at risk from externalities. Investing in banks depends on the long-term ROE that they can generate and we think that is anyone's guess.

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The mark-to-market losses from long-dated government and corporate bonds and loans that are at the core of the current crisis are an inevitable result of the rate rises last year. That is why this crisis may be the first to have been caused directly by central banks themselves and we expect there to be further impacts before it is resolved.

The mark-to-market losses at Silicon Valley Bank and First Republic did not matter until there was a run on the bank. These days all it takes is for people to click on a website to move their money. The losses Credit Suisse incurred on Archegos or Greensill were terrible and a key reason investors lost confidence. Other banks did not make the same mistakes. But we had no way of knowing when there would be a run on Silicon Valley Bank and First Republic or how great Credit Suisse's exposure was and how it compared to other banks.

Many banks are well run by experienced financial professionals. But being well run is not enough to get us to buy their shares. Banks are designed to fail as Martin Wolf wrote in the *Financial Times* last month. In the recent bank failures depositors have been bailed out by governments who decided that doing so is better than risking the economic and political fall-out. Shareholders suffered massive losses.

However, this doesn't mean that we don't care deeply about banks. They fulfil important economic, social and political functions. We want them not just to survive but to thrive. We just don't want to invest in their shares.

Our managing partners Jerome Stern and Tom Price had a webinar last month in which they discussed the implications of the banking crisis for investors. It was well received and you can listen to it by going on our website https://www.jsternco.com/webinar-turmoil-at-the-bank/.

Christopher Rossbach
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