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Bank Stocks—A Review

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Over the past two and a half years, we've held a sizable position in large cap bank stocks. This position initially consisted of JP Morgan and Wells Fargo (both warrants and common), and last year I added a position in Bank of America (initially in February and then I made the BAC position larger in June during the "Brexit" correction). Collectively, this large cap bank basket (mostly JPM and BAC) was our largest position.

As I've talked about before, my general thesis was that the banks were very good businesses with valuable low-cost deposits as a primary funding source, sticky customer relationships, scale advantages that have become more important in the Dodd-Frank era, simplified and much safer balance sheets, and huge cash flows (banks have been making record profits each year for the past half-decade or so despite all the talk about how low interest rates hurt banks' earning power).

Despite really positive fundamentals, for years the banks continued to trade at very cheap multiples relative to earnings (often times below 10 P/E), which I thought represented good value for the price paid.

In my mid-year letter last July, I outlined some comments on the banks that I thought I'd share here:

> *Our current portfolio continues to be weighted abnormally toward a few select large-cap stocks that I consider to be very cheap. The bank stocks continue to be valued as if another financial crisis is likely. Bank balance sheets have never been stronger in terms of leverage ratios and asset quality. And while lower leverage (a good thing) also reduces return on equity, bank earning power has never been stronger.*
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> *Last year in 2015, the US banking system earned $163 billion, more than any other year in history. And unlike years past where earnings were inflated by gearing up a bank's balance sheet with opaque, illiquid assets that in some cases exceeded 30 times the bank's equity capital, earnings this time around have been achieved with a much more straightforward and clean balance sheet.*
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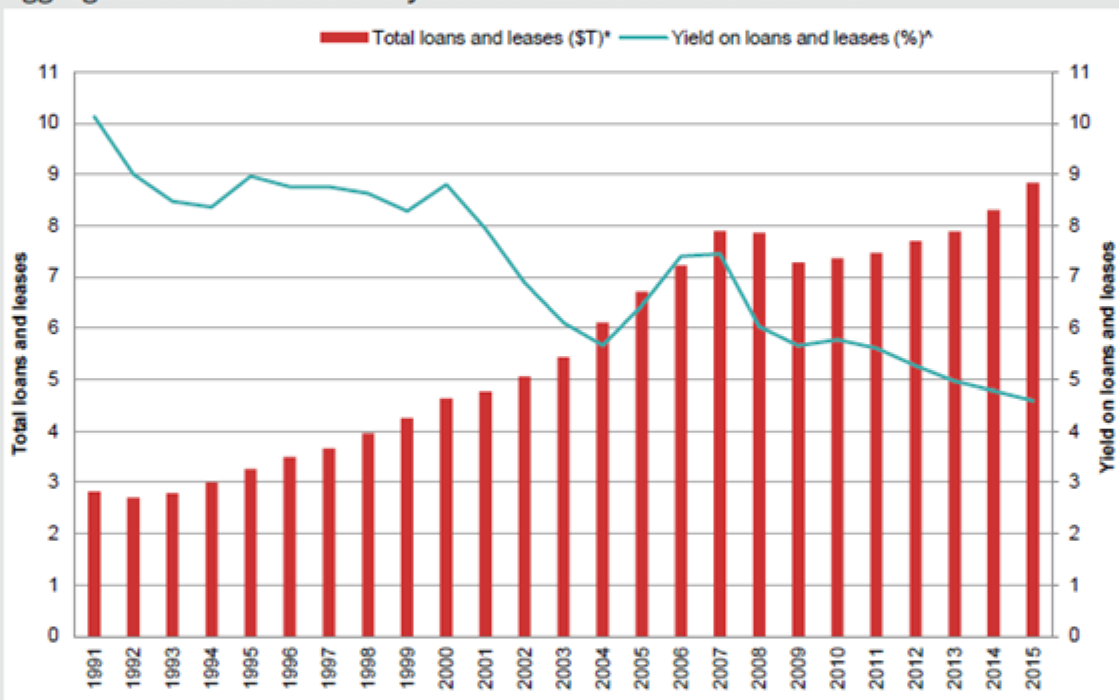
> *Also, not only are bank profits at all-time highs, but profit margins are at all-time lows. Net interest margins (NIM)—an industry metric that measures the difference between the amount of interest a bank collects on its loans and securities and the amount of interest it pays to depositors, relative to the amount of the bank's assets—are at the lowest levels since record keeping began.*

*This chart shows the gross yield on loans relative to the total amount of loans in the banking system. Banks are earning more and more profit, despite collecting less and less on each dollar they extend to borrowers:*

Aggregate loan balances and yields across US banks and thrifts




Data compiled Feb. 8, 2016.
Based on regulatory filings for commercial banks, savings banks and savings and loan associations.
* Total loans and leases include held-for-sale loans and leases.
^ Yield on loans and leases represents interest and fees on loans and leases, as a percentage of average loans and leases.
Source: S&P Global Market Intelligence

*Should interest rates begin to rise at some point, the banks we own will likely see huge increases in earning power. For example, Bank of America would see an additional $5 billion in profits if interest rates rose 1%--all else being equal. This is a significant increase for a bank that is currently earning around $16 billion after tax. This would put the bank's earning power at around $2 per share. Even without any benefit from rising yields, the bank currently has tangible book value per share of $16.68. As the bank continues cutting costs, a 10% return on tangible equity should be easily within reach, which would imply around $1.70 of earnings—and a company currently valued around 8 times earnings.*

*Banks are flush with cash and have huge amounts of highly liquid securities, and continue to have a large amount of dry powder. Loan to deposit ratios have begun climbing slightly, but are still near multi-year lows (banks generally make money by taking in deposits and lending them out at higher interest rates—and measuring the amount of loans relative to the amount of deposits a bank has is a back of the envelope way to determine how much potential there might be for loan growth in the future—the lower the loans to deposits ratio, the more potential a bank has to write more loans in the future). Like a factory that is being underutilized, bank balance sheets have much untapped earning power.*

One of the central pillars to my bank stock investment thesis is that banks have traded at unreasonably cheap levels for years because of the painful memory of the financial crisis. The severity of this crisis—especially in regards to bank stocks—has significantly lengthened the emotional recovery time. In other words, investors are looking in the rearview mirror at the last crisis much longer than they normally would. The fear of another crisis has caused bank stocks to be priced at levels that were disconnected from their true intrinsic values.

When I wrote that mid-year update just six months ago, JPM was trading around $60 and BAC was trading around $13. These prices meant that the two banks were trading at very low prices relative to their normal current earning power (P/E of 9 and 8 respectively).

Since then, the bank stock pendulum finally seems to be swinging back toward a more reasonable valuation. Many people have posited that this is largely due to the election of Trump, but bank stocks had already risen significantly in the third quarter and through October, before the surprise election result. Regardless of why, bank stocks—for the first time in almost a decade—are seeing some optimism priced into their shares. While I still think the companies are doing well and the share prices are reasonable, they are no longer bargain-priced, and so I've reduced the size of that position accordingly.

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*John Huber is the Managing Member and Portfolio Manager of Saber Capital Management, LLC, an investment firm that manages separate accounts for clients. Saber employs a value investing strategy with a primary goal of patiently compounding capital for the long-term.*

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