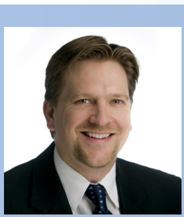
Alphinity
INVESTMENT MANAGEMENT

Sector spotlight

March 2014

Each quarter, Alphinity Investment Management's portfolio managers share their expert views on the trends and themes emerging within their relevant sectors. This quarter, Andrew Martin shares his thoughts on the bank sector and where the risks lie.



Who: Andrew Martin
Role: Principal and Portfolio Manager
Sector responsibilities: Financial Institutions
Industry experience: 18 years

Is the banking sector overpriced?

It is hard to find a valuation measure that says banks are cheap. As it stands, price to earnings ratios are currently around 10-15% above long run averages, yields are below 6% p.a. and the huge gap which previously existed between bank yields and bond yields has now closed materially. However if we assume no significant change to economic environment, the banks aren't outrageously expensive either. They remain one of the few sectors where earnings continue to be upgraded.

What has driven the banking sector's strong returns and dividends over the past two years?

If we look back to mid-2012 Australian bank price to earnings ratios had fallen to 20% below long term averages, with Europe in turmoil and bank regulation uncertain. What really stood out were the high dividend yields available (c. 6-7% p.a. fully franked) and importantly the gap between these yields and bond yields increased to unprecedented levels as bond yields fell.

Australian banks were very well capitalised and had much lower credit and balance sheet risks compared with their international peers. The Australian economy was strong and while other international financial institutions struggled, Australian banks grew, increasing their relevance to global investors. Significantly our housing market was holding up well and interest rates were falling, providing further support. Finally, the fallout from the GFC meant the major Australian banks had very little domestic competition, leading to growth in their market share and an unchallenged ability to reprice their lending products. This allowed banks to grow earnings when others couldn't, and ultimately produce higher, safer dividends which investors were after.

With the scene set, the spark that was needed to light the fire under bank share prices came about with the first concrete signs that Europe was stabilising in 2012.

What factors affect the stability of the Australian banking sector?

There are five key points to keep in mind; **capital, liquidity and provisions**, how much does a bank hold for when things go wrong; **credit quality**, the ability for loans to be repaid to the bank and the value of the security behind those loans; **regulation**, how banks are being monitored and kept in check; **funding**, how banks get the money that they then lend out; and finally **competition**, the level of price discounting by banks to win business.

The domestic banking sector appears quite secure for now. We have a strong and conservative banking regulator, and we have some of the strongest capitalised banks globally, combined with a relatively robust and highly rated economy acting as a backstop.

It is unlikely credit quality issues will become a significant risk for banks in the near term. Australian corporates have de-geared and domestic savings rate is high, while interest rates are low, asset prices up, and credit growth has been tepid.

Having said this, a continued increase in the unemployment rate could be taken negatively for banks given their very large exposure to housing mortgages. The major banks have loan losses below long run averages so investors will be looking for any risks that might see that pick up.

What else should investors consider before investing in the banking sector?

There has been an increase in competition as liquidity and funding markets have significantly improved. In turn, the ability of banks to continue to take market share and lift pricing has diminished. Driving revenue growth has become increasingly difficult in a low credit growth environment, and so banks have turned their attention to cost. We expect future earnings growth to come from the banks that can control their operating costs the best.

Regulatory risk has been a significant feature for banks since the GFC and will likely remain so to some degree. Recently capital requirements were revised up yet again, and lately we see international regulators becoming even more interventionist in their approach. There is also a new uncertainty emerging around the Murray financial system review being undertaken this year. We expect a lot of discussion around the review, although we don't anticipate any major negative impacts in 2014.

One of the reasons banks have outperformed other sectors in the last 2 years has been their consistency in producing earnings growth above expectations and above other sectors. Banks will most likely not enjoy that benefit to the same degree this year, with other sectors, also returning to more positive earnings momentum than recent history. The underperformance of Resources for much of the last two years had a significant positive impact on bank outperformance as investors sold resource stocks on earnings concerns and reinvested in the stable earning of the banks. As earnings stabilise and recover in a range of sectors the relative attractiveness of banks earnings may diminish.

Assuming earnings expectations are met, investors can still earn a decent fully franked yield achieved with a high degree of certainty in 2014, but in a relative sense it is hard to see bank share prices achieving the same levels of outperformance seen in recent years. While many of the positives that drove bank share prices since 2012 remain to some degree, the vast portion of benefit derived from these has occurred already.

For more information please contact our Investor Services team on 13 51 53 or visit alphinity.com.au

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