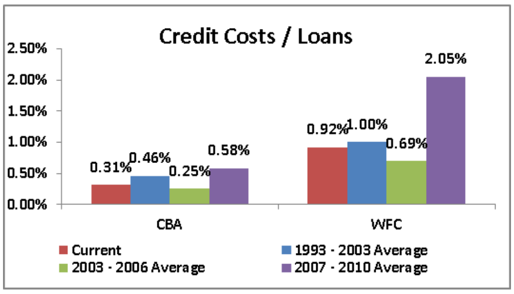
A comparative look at banks

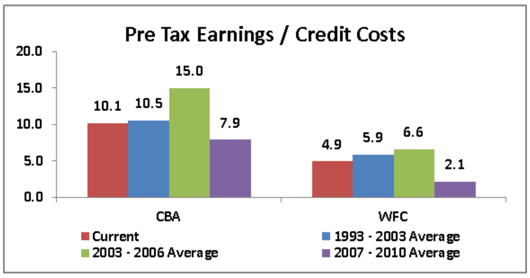
Looking at stocks from a global perspective, we believe, gives us a unique opportunity to compare and contrast businesses both on a relative and absolute basis. We have found over the years that what we learn about sectors and businesses in one region can be used to set a context for investment decisions in relation to businesses in other geographies. We believe that investors can generate better returns when they look at stocks from a global perspective, whilst also incorporating regional factors, in making investment decisions. One sector which we believe is more tightly incorporated to global business cycle than others and lends itself to cross regional analysis is the banking sector. Our analysis of global banks, in particular domestic banks vs US banks has highlighted to us the valuation that the domestic banks are trading on is hard to justify when compared to both the valuation and operational metrics for international banks as well as their own historical operational and valuation metrics. To highlight our thoughts we use Wells Fargo (WFC) which is the largest retail bank in the US and compare it to CBA – which is the largest retail bank in Australia.



Source: Factset, Fiscal Year End Data

Credit losses as a percentage of loans has been an operational metric that has been given a lot of focus because credit losses were the largest contributor for sharp contraction in bank profitability globally during the GFC. The above chart shows how credit losses which averaged ~1.00% for WFC during 1993 – 2003 period fell to 0.69% during the boom period (2003 – 2006) in lead up to the GFC, rose to an average 2.05% during the GFC period of 2007 – 2010, representing 2x losses compared to pre boom period averages and 3x compared to boom period average. For the same periods, CBA only saw its losses rise from an average of 0.46% pre the boom period to 0.58% (only a 30% increase in losses). This highlights that the profitability for Australian banks contracted significantly less than US banks post the GFC. Moving to current operational metrics, the recovery in the US economy has benefitted WFC and its credit losses for FY12 were only 0.92% - almost inline with its historical pre boom average. In contrast, credit losses for CBA were 0.31% - representing a 30% discount to pre boom average. This highlights that while US banks are operating in line with historical metrics, CBA (indicative of Australian banks) is operating better than it did before the GFC.

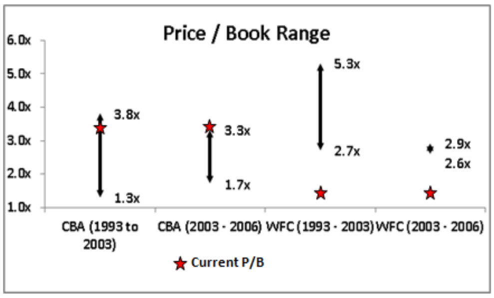
Similar conclusions can be made when we look at pre tax earnings vs credit cost metrics. This measures the ratio of pre tax earnings and credit costs and the higher this metric is, the better the operational performance is.



Source: Factset, Fiscal Year End Data

Under this metric, we can again see that CBA is operating close to its pre boom average of 10.5x. Where as WFC is operating at ~20% discount to its pre -boom average. This operational metric also suggests that Australian banks are operating at historic average and have limited upside, where as with US banks there is still 20%+ upside in operational performance, particularly in relation to credit losses

Valuation metrics however tell a different story. Price to Book is a widely used metric when assessing bank valuations as it links ROE generated by a bank, shareholders equity and share price. In essence it provides a good theoretical construct which links operational performance (ROE) with market valuation.



Source: Factset, Fiscal Year End Data

The above chart shows that even though Australian bank operational metrics are inline with historical averages, the valuations are near highs. P/B for CBA currently is 3.4x vs its peak P/B during the pre GFC boom of 3.3x. As a comparison, WFC which is operating only ~20% below its historical average is trading at 1.3x P/B – nearly 50% discount to its historic valuation. We think this cross geographic comparison shows that both on a historic and relative basis CBA is trading at a significant premium to what its operational metrics would suggest when viewed from a global perspective. Though credit losses are only one aspect of operational performance, we believe that this analysis applies for other key operational metrics that bank performance is gauged by. As a result we believe there is limited upside in Australian banks, in particular CBA. As a result we have positioned the AOF to be underweight Australian banks, even though we have an overweight position in US banks in APF.

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