Global financial stocks could see a multi-year recovery, says UOBAM's Doyle

| BY KELVIN TAN |

The past few years have been tumultuous for global banking and financial stocks. Weighed down by the 2008 global financial crisis, last year's equity market downturn and the European banking crisis in 3Q2011, many listed banks and financial companies around the world have seen a steep plunge in their stock prices over the past five years. But with many of them making good progress in terms of deleveraging and cleaning up their balance sheets, is the worst over for global banking and financial stocks?

For some perspective, *Personal Wealth* recently spoke to John Doyle, chief investment officer of equities and asset allocation at UOB Asset Management (UOBAM) and manager of the United Global Capital Fund. His fund won two awards at *The Edge*-Lipper Singapore Fund Awards 2012 for best fund in the Equity Sector Banks and Other Financials category over three and five years. The bullish Doyle, who likes US and emerging market banks as well as credit card companies such as Visa and MasterCard, reckons the global banking sector is at the beginning of "a multi-year recovery". Here are excerpts from the interview.

UOBAM

Doyle: The fund's largest relative exposures are in the payment services area

The United Global Capital Fund was the best performer in its category over the past one, three and five years. What factors have been instrumental to the consistency and superior relative performance of your fund in recent years?

Our investment approach taps deep, as well as wide, industry knowledge and expertise to identify the most interesting business segments within the financial services sector. We start by applying Porter analysis to understand the industry structure, competitive factors, entry barriers and growth potential of the various sub-sectors. We actively benchmark companies and take a position in the strongest franchises globally. Securities selection adopts a bottom-up process whereby a detailed analysis of what is driving the selection is done at the start of the process. Our long-term approach is also reflected in the fund's low turnover rate. Many of the fund's top holdings have been in the portfolio for years, whereby these businesses and their share prices have grown, contributing to the fund's performance.

After the 2008 crisis, banks and financial institutions have been forced to deleverage on the back of crippling debts. Deleveraging is still going on at many European financial institutions. In your opinion, is the worst over for global banking and financial stocks?

The challenges faced across the industry differ across the world as well as across sub-sectors. In traditional lending areas, we are starting to see excellent opportunities arising in the US, where the stronger banks are seeing a revival in profitability and opportunities for growth. Much of this growth is being achieved at the expense of some of the large weaker players that are still rationalising their businesses. **US Bancorp** is an example of an institution that has benefited from the crisis, and it continues to grow from strength to strength.

In Europe, the outlook is still fairly bleak for traditional lending banks. We have been looking for opportunities in more retail-oriented banks in Europe and have avoided wholesale-oriented institutions (or institutions with large corporate and investment banking businesses) as there is still significant adjustment ahead.

The fund has de-emphasised traditional lenders in Europe, although we continue to hold **HSBC**, which has a strong capital position and is in a solid position to potentially take market share from many of its competitors who are still crippled.

Elsewhere in the world, especially in some of the emerging markets, we have found excellent investments in traditional lenders. Examples include **Itau Unibanco** (Brazil's largest private bank), **Banorte** (a large commercial bank in Mexico), **Housing Development Finance Corp** (India's leading mortgage bank) and **Bank Rakyat Indonesia** (a micro lender). So there are still some excellent opportunities in traditional lenders.

What are some of the factors that could spur global financial stocks higher this year?

Clearly, earnings are the single largest driver. With credit conditions starting to improve and revenues starting to expand, we expect that profitability will continue to trend higher. This should help drive valuations higher, potentially closer to pre-crisis levels. However, there are still a number of uncertainties, and regulatory change remains a work in process. Some of these changes will act as a headwind for the sector. We believe we are at the beginning of what will likely be a multi-year recovery for the sector.

The sovereign debt crisis in Europe remains the single greatest risk to the sector's outlook. While the problems in Europe are largely contained to European banks, a disorderly default in Greece and its contagion [effect on] the core of Europe will have global implications as it could push Europe into a deep recession. We continue to monitor Europe closely and hope to see closure of the sovereign problems sooner than later.

Which two financial sub-sectors are you most bullish on over the next 12 months?

The fund has targeted segments such as payment processing, trust and custody and asset management that are not impacted directly by concerns over credit or risks arising from deleveraging.

For the payment services segment, changing payment patterns from cash and cheque to electronic are driving significant growth opportunities. High barriers of entry for network clearing companies and the consolidation of payment activities to a handful of dominant merchant acquirers have enhanced profitability across the value chain.

The fund has also looked for opportunities in the trust and custody and wealth management segments. Similar to the drivers of the payment services sector, these segments have fairly stable competitive characteristics driven by high barriers of entry in the trust and custody segment, as well as cost and scale advantages in the wealth management area. Both segments typically generate above-average revenue growth across a business cycle as well as superior risk-adjusted returns on capital.

Many of the fund's largest holdings are in these areas. Examples include **Visa Inc**, **MasterCard Inc**, **State Street Corp**, **Northern Trust** and **Aberdeen Asset Management**.

Top 10 holdings

NAME
Visa Inc – Class A Shares
US Bancorp
MasterCard Inc – A
HSBC Holdings plc
Northern Trust Corp
Itau Unibanco Hld Sa – ADF
PNC Financial Services
State Street Corp
Bank Rakyat Indonesia
Aberdeen Asset Management plc

** As at end-January 2012*

UOB ASSET MANAGEMENT

Which two stocks are you most positive about at the moment?

The fund's largest relative exposures are in the payment services area. Visa and MasterCard operate the world's largest retail payment clearing networks and benefit from the shift to electronic commerce. While fees in the payments area continue to decline owing to market and regulatory pressure, these payment processing businesses have continued to generate positive operating leverage by being able to reduce unit costs due to volume increases. The entry barriers in the payments clearing segment are high given the volume share gains achieved by these brands. Volume growth in transactions processed across the two networks will continue to drive revenue and profit gains for the foreseeable future. While these companies may seem expensive compared with traditional lending institutions, they have much more visibility on both growth and profitability than the broader financial services segment. Our models suggest that they remain undervalued.

Banks in Asia ex-Japan are said to be among the strongest in the world based on fundamentals. Yet, none of them seems to be in your top 10 holdings. Tell us why, and which Asian banks do you like best?

The fund holds a number of banks in Asia. However, these tend to come from emerging Asia, not developed Asia. Developed markets in Asia face challenges that are not reflected in capital or liquidity ratios. Risk-adjusted loan pricing in many developed markets has fallen to unacceptably low levels due to competition. The recently benign credit backdrop for Asia is likely to be masking potential credit problems and giving a false sense of balance-sheet strength. So we are highly selective in terms of how we deploy capital in the region.

At the moment, our preferred markets in Asia are India and Indonesia. Loan pricing in both markets is highly attractive and we have been able to find some of the most profitable banks in the world in these two markets. Currently, HDFC [India] and Bank Rakyat Indonesia [Indonesia] are among the stocks to which the fund has relatively higher exposure.

HDFC is the leading mortgage lender in India. The company continues to generate attractive growth, has a rock-solid capital base and produces among the highest returns of any financial services company globally.

Bank Rakyat Indonesia is the leading micro lender in Indonesia. The company's large market share has given it an advantage in terms of economies of scale over its competitors. The business continues to generate among the best risk-adjusted margins of any credit institution that we monitor globally.

Over the next several quarters, what would be the main risk that could cause another big sell-off in global financial stocks?

The first risk is, unsurprisingly, the eurozone debt issue and the economic weakness in peripheral Europe. Weakness in Europe and the need for the European banks to restructure are having both a direct impact on their future revenues and a global impact as they reduce balance-sheet exposures in order to conserve capital. This is impacting the availability and cost of credit in wholesale lending segments across the world.

Due to the uncertainties over how the credit backdrop in Europe will evolve and the ongoing challenges in the corporate and investment banking and wholesale banking segments, we have deliberately reduced exposure to European banks. We believe their strategic repositioning ahead of the adoption of Basel III has several years to run, and the profit outlook remains clouded.

The other major risk that we continue to monitor is closer to home — the credit backdrop in China. The significant overhang in the commercial and residential real-estate sectors in China, along with high local-government debt, has the potential of having an adverse impact on the banking sector, and, more worryingly, a sharp decline in fixed-asset investment and economic growth. This could materially and adversely alter the credit and solvency picture of the broader financial system in China. We believe policymakers will continue to push for banks to lift their capital buffers in order for them to absorb losses. Until the dust settles on the real estate sector, we will likely avoid making any significant investment in Chinese banks. E