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Insights: Magellan Minutes

Part 7. Challenges facing the banking sector with Alan Pullen, Head of Financials and Portfolio Manager

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Alan Pullen, Head of Financials and Portfolio Manager
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Jennifer Herbert:

Hello, and welcome to our investment insights series, Magellan Minutes, in which our investment team dissects the markets and takes a deeper look into sectors and stocks in our global portfolios. My name is Jennifer Herbert, Key Account Manager at Magellan and over the next 10 minutes, I'll be speaking with Magellan's head of financials and portfolio manager, Alan Pullen, to give you our thoughts on the banking sector. Thanks for joining us, Alan.

Alan Pullen:

It's a pleasure, Jen.

Jennifer Herbert:

Alan, Magellan reduced its exposure to the banks to virtually zero last year, and that was way before covid-19 hit. Could you talk us through the rationale behind this?

Alan Pullen:

We've been cautious on the banks for some time now, mainly reflecting two factors. Firstly, we were increasingly of the view that interest rates around the world were likely to stay lower for longer. This was because, despite the long economic expansion and very low levels of unemployment in places such as the US, we had yet to see inflationary pressures really pick up. It appeared that demographic forces such as the ageing of the population, high levels of indebtedness around the world, and the relentless disinflationary forces of technology were conspiring to keep inflation under control and, consequently, interest rates low.

Now, banks make their money on the difference between the interest they charge on loans to borrowers compared to the interest they pay on deposits. As you probably noticed yourself, banks were already paying very little to depositors. In fact, they don't pay any interest at all on many deposits, such as those held in transaction accounts. So, as interest rates decline and the interest income they earn on loans declines – and as they can't reduce what they pay for deposits as much – profits go down.

The second reason we are being cautious is the potential for technology to disrupt traditional banks over time. People no longer need to go into branches to do their banking. Of course, right now, it's preferable not to. But even before the virus, people were increasingly banking online. This allowed the possibility of new technology-enabled competitors to traditional banks.

What we actually worry about the most is what we term the disintermediation of the customer relationship. People are increasingly comfortable interacting with technology and trust technology companies with aspects of their financial lives. Just look at the success of Apple Pay. While we don't think big tech companies want to become banks themselves, which would come with a lot of regulation, we think they'd be more than happy to become the platform through which individuals manage their finances, and relegate banks to the dumb pipes at the back end, which would, again, impact bank profitability over the long term. So, given the concerns about low rates and the potential for disruption of banks' traditional business models we're cautious on the banking sector.

Jennifer Herbert:

The pandemic has hit the banks hard. Why is that? What's going on?

Alan Pullen:

The banking sector is potentially one of the most impacted by the pandemic. Banks are leveraged to the health of the underlying economy, which has taken an almost unprecedented hit. Large swathes of the economy are closed, many people unemployed. Businesses are shut and individuals are unable to earn a living or repay their loans. This will result in increasing bad debts for banks. Government support for impacted industries and individuals around the world has been pretty significant. And banks are allowing people to delay repayments, and that'll help in the short term. But, ultimately, we still don't know how effective this will be. There are still huge unknowns about the health outcomes and the pace of reopening of the economy and just how much damage has been done. Damage is eventually going to show up on bank balance sheets.

And while the unknown quantum of bad debts is the most immediate impact of the pandemic for the banking sector, central banks have slashed interest rates in response to the crisis. As we were talking about earlier, low rates are a headwind for bank profitability. It looks if we're going to have central bank interest rates at zero, or even below zero in some parts of the world, for some time to come.

Jennifer Herbert:

And does this apply to Australian banks as well?

Alan Pullen:

Look, this has been a global pandemic and Australia hasn't been spared the economic impact. Thankfully, through some good policies and some good luck, Australia managed to avoid some of the health outcomes experienced overseas. However, the economic impact of the lockdowns has been significant. In addition, as a relatively small open economy, Australia will continue to be impacted by what happens internationally. Historically, Australian banks have been some of the most profitable in the world, but they too will face the prospect of a significant increase in credit costs as we deal with the pandemic.

Jennifer Herbert:

So, what lies ahead for the sector? Are there pockets of value that you may start looking at again soon?

Alan Pullen:

That's a great question. Look, as with any other company, if the negative outlook for banks has been fully reflected in the share price, that could actually still prove to be a pretty good investment. In fact, in times like this, people can become too pessimistic, which can open up the opportunity to buy quality companies at a discount. Unfortunately, we just can't be confident we're at that point. The level of uncertainty is simply too high. We are still uncertain about the epidemiology of the virus. Will there be a second wave? How effective will treatments be? When will there be a vaccine, if at all, and so on. And we don't know how quickly the economies will open up, and if the response from governments and central banks will be sufficient to offset the unprecedented disruption to economic activity that we've seen. With all these unknowns, making an informed judgment on whether banks are currently attractive investments is not possible. In some cases, they may be, but it's just not a risk we're willing to take, given our focus on downside protection.

We only cover a few select banks around the world; those with significant competitive advantages and their strong history in managing credit risk. But when you combine the current uncertainty with the likelihood of continued, very low interest rates and potential disruptive threats I talked about earlier, banks face a significant hurdle for inclusion in the portfolio. What could change that? If we could gain more confidence in the likely path of economic activity that would allow us to sensibly assess banks' intrinsic value, if they then offered a sufficient margin of safety to overcome our concerns, then they could again be considered.