Castlebay Investment Partners

Security through compounding: Knowledge, Returns & Trust

Why we don't own Banks—when confidence fails!

Dear fellow shareholders,

Given recent developments in financial markets, it is probably worth reiterating the reasons why we don't invest in Banks. Firstly, a couple of admissions. 'Back in the day' when I was with Resolution Asset Management, I was a Banks' analyst in the years before the music stopped in 2008, with the Global Financial Crisis. Just as I was leaving to embark on the next chapter of my career, Resolution rebranded itself. A quick check of the financial news confirms the ironic nature of this rebranding when the company changed its name to 'Ignis'. Latin aficionados will already know that this means fire, burn or spark. It's presumably from where we take the word ignite. The then chief executive, Mr Gavin Stewart, thought the name 'encapsulated [the company's] ethos, dynamism and future ambitions.' Little did he know that a mere eleven days later the global financial world was about to burst into flames—with little help from a Glasgow based fund management group, following the bankruptcy of Lehman Brothers in the US. This set in motion five months of panic. With an injudicious timing exceeding that of even Mr Stewart, here is my second 'mea culpa.' I managed to arrive at my new employer's office on 15th September 2008—the day Lehmans actually collapsed. The issue? My new employer was Barclays! I'm actually surprised they let me in the front door, but having negotiated that particular hurdle I was greeted by a sea of red, as share price falls were displayed on all the monitors around me. Sometimes it's all in the timing!

I mention all this to underline the point that it is no coincidence, in light of these earlier career experiences, that we don't invest in Banks. There are several reasons why this is the case, but the three main ones come down to —**leverage, returns and confidence.** Let's look at them in turn. Firstly, **leverage**. I often think of Banks as the petrol pump attendants of the economy. As companies and consumers drive into the petrol station, they are the ones who provide the fuel that keeps the economy moving.

Company	ROE	Leverage (Total Assets to Equity) x	Equity to Total Assets %	Non Performing Loans/Total Assets %
HSBC HOLDINGS PLC	8.6	17.2	5.8	0.7
NATWEST GROUP PLC	9.5	21.5	4.7	0.7
LLOYDS BANKING GROUP PLC	12.5	19.8	5.0	0.9
BARCLAYS PLC	9.0	25.9	3.9	0.5
STANDARD CHARTERED PLC	5.7	18.5	5.4	1.0
Average	9.1	20.6	5.0	0.7

Source: Bloomberg as at 31/03/2023

What makes Banks unique is that their supply of fuel actually comes from other businesses and customers in the form of deposits. We deposit our money in a bank and get a low interest rate and they then lend it out at a higher rate. That's how they make a lot of their money. From the banks' perspectives our customer deposits represent their liabilities—because we can generally ask for them back at anytime. The banks take these deposits and create loans which sit as assets on their balance sheets. The difference between Assets and Liabilities for any company, as well as Banks, is the Shareholder Equity.

In the table above you can see this shows the five largest listed UK Banks. The 'Leverage' column takes Total assets and divides it by the Equity. You can see at the bottom row that the Average Leverage sits at around 20x. The next column effectively reverses the calculation. So it asks what percentage of Total Assets is made up of Equity. The answer for the Banks' average is 5%. In other words, if the UK Banks all had Total assets of £100, the equity would be £5 by comparison. The really important thing for Bankers to remember—and history shows it is regularly forgotten, is to ensure that you get back the money that you lend out. Unfortunately, due to the uncertainties of life, businesses and people can't always pay back their loans. The last column 'Non performing loans/Total Assets' looks at the percent of loans that are potentially not going to be paid back.

So here we are looking at £0.70 of the £100 of Assets that could potentially be lost. Importantly, if these losses rise from under 1% to 5% of Total Assets, all of the Shareholders' Equity is wiped out. You can imagine what happens to the share price of a bank in that situation. It isn't pretty. What's more—it's happened before. Take Lloyds Bank in the table. In the aftermath of the Global Financial Crisis its non performing loans rose to over 6.5% of its Total Assets. That's leverage for you. It's the cause of most bank failures —due to these 'hidden losses'. It's an unavoidable part of the banking business model. We don't like it though and it's one of the main reasons we avoid banks.

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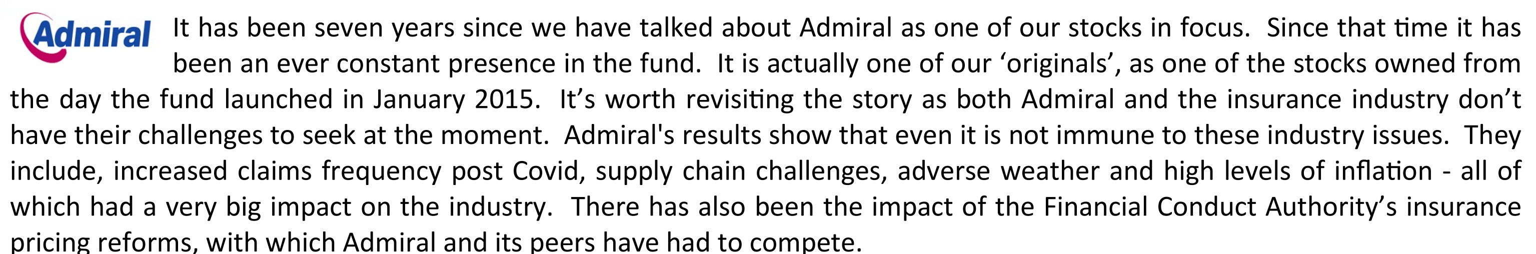
As an aside, on the eve of my new job at Barclays, the European banking sector had a collective leverage of around 40x! Since the 2008 crisis and the regulatory response, Banks have had to repair their balance sheets and put more capital aside to reduce these leverage levels. The petrol pump attendants have been on strike, using the fuel to strengthen their own balance sheets. It's one of the reasons that economic growth has been so low in the intervening years and why inflation has only manifested itself relatively recently. It's also one of the reasons that **returns** have declined - our second reason for not investing in banks.

Returns: Simply put the **Return on Equity (ROE)** for banks is too low to get into our Investment Universe and by extension our fund. We look for a minimum 20% ROE. Yet as the table above shows, both individually and on average the UK banks struggle to make half our minimum required return. All that financial leverage for such little reward. Furthermore, UK banks tend to be large dividend payers. This lowers further the rate at which capital can be reinvested into the business, thus limiting the future value creation for shareholders. This is a really important point to consider. As we've mentioned many times, we are disciples of the Charlie Munger principle—where the share price follows the underlying returns over the long term. Since we launched our fund over eight years ago, the UK Banking sector has returned only 1% in total return annually. That's not surprising given their average 9.1% ROE and how much they payout in dividends. That's why this sector share price performance has broadly followed this low Retained Return on Equity, as Mr Munger's aphorism would suggest.

Our third reason for avoiding banks is about **Confidence.** In the early years of my time at Resolution I well remember being told about the 'Two Cs' of business. For most businesses **Cash** is king. Companies need to generate more cash from their operations, over a business cycle, than they pay out in expenses. Thus a cash profit is generated and this can be retained and reinvested in the business, maintaining it as an ongoing concern. For Financials the other 'C' for **Capital** is normally critical. Capital needs to be set aside to meet the needs of the business and ensure its viability. However, over the years in the Banking sector, uniquely, a third 'C' is critical above all else — **Confidence.**

I have reflected on this recently, during the failure of Silicon Valley Bank (SVB) and the rescue of Credit Suisse through the takeover by UBS and a couple of things strike me. Firstly, the '**duration of financing'** for Banks is much more uncertain compared to other businesses. When you look on the liability side of a balance sheet you will often see 'Borrowing and other financial liabilities', firstly in 'current liabilities' - therefore due within one year; and then the same in the 'non-current liabilities' - due after 12 months. However, for a Bank it doesn't really know the duration of the deposits given to it by its customers. When confidence erodes and people demand their money back this can create both a **liquidity issue** and ultimately a **solvency crisis**. At the risk of being seen to defend the management teams at banks, it does make the effective allocation of capital very challenging for them. Especially, when trying to create long term value for shareholders. All of which leads me to another thought? For whom are banks run? As public, listed entities the obvious answer should be shareholders. However, through the misalignment of incentives, more often than not, banks are run for the benefit of their management teams and a small number of senior employees. For this cohort, high rewards with little downside risk can often lead to unsustainable risks being taken. So there you have it: high leverage, low returns, confidence dependent business models and uncertainty over financing, just some of the reasons we don't invest in Banks!



It has been seven years since we have talked about Admiral as one of our stocks in focus. Since that time it has been an ever constant presence in the fund. It is actually one of our 'originals', as one of the stocks owned from the day the fund launched in January 2015. It's worth revisiting the story as both Admiral and the insurance industry don't have their challenges to seek at the moment. Admiral's results show that even it is not immune to these industry issues. They include, increased claims frequency post Covid, supply chain challenges, adverse weather and high levels of inflation - all of which had a very big impact on the industry. There has also been the impact of the Financial Conduct Authority's insurance pricing reforms, with which Admiral and its peers have had to compete.

Subsequently, Admiral's pre-tax profits saw a decline from £769m to £469m. The group's insurance loss ratio (claims paid out/ earned insurance premium) rose 14 percentage points to 72% - due to a rise in claims inflation; with the group's expense ratio (underwriting expenses/earned premium) rising 3 percentage points to 30%. The cumulative 17 points rise led to an underwriting loss for the first time in recent decades, reflected in a Combined ratio of 101.7%.

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However, this should be seen in the context of the industry, which will likely produce a Combined ratio of 115%. Admiral will also reprice risk to reflect these industry pressures, over the coming months. Given the reduction in profits, Return on Equity has also declined from 52% to 35%. Yet, Admiral still maintains industry leading returns due to their strong capital allocation discipline. The sector has recently produced an average Return on Equity (excluding Admiral) of only 2%! Covid and its after-effects have distorted the marketplace over the last couple of years, but we anticipate Admiral's Return on Equity getting back to previous levels soon.

Admiral maintains this 'returns' advantage by taking risk off its balance sheet through its relationships with Reinsurers, such as Munich Re. It has also historically been a very good allocator of capital, which means it doesn't chase growth in the insurance sector for the sake of it. It often takes a step back from the insurance premium cycle when competitors are going for growth. This has created a lot of value for shareholders over the years. Interestingly more recently, following its investment in technology and the development of its loans business, Admiral appears to be getting better at setting the right insurance premia for the right customers, helping it manage the industry cycle even better.

Given the resilience of their business model, we anticipate that Admiral will emerge from recent issues and continue to take market share whilst creating good value for shareholders over the long term. The signs are there already with their strong customer growth in the Household, Loans and Travel businesses, all of which enhance their core car insurance business.

Quality Table: The premium in Quality of our businesses remains intact in comparison to the market, as evidenced by our Return on Equity and Operating Profit Margin figures. It is true that the market's operating margin has increased slightly from 13% to 14% over last quarter. However, we would still make the point that we believe a large part of this rise is being driven from the more cyclical sectors—seemingly at peak profits, which we would anticipate declining as the cycle rolls over. How sustainable will the market's profits be and by extension its margin and free cashflow yield? We should get a clearer idea over the new few quarters.

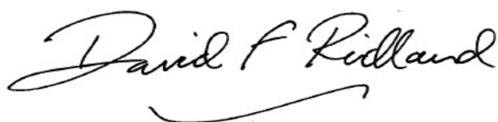
Quality Table	Castlebay Fund	Market
Return on Equity	41%	16%
Operating profit margin	21%	14%
Net debt to equity	60%	76%
Cash conversion	95%	93%
Free Cashflow yield	4.6%	4.9%

Source: Bloomberg as at 31/03/2023

As we said in our last letter, we believe that we continue to have a collection of really good businesses, delivering robust financial results, which are being offered to us at very attractive prices and valuations. Our companies are not only resilient but can continue to benefit from the economic uncertainty and inflationary environment, as they do something different which people value. This in turn allows the businesses to reinvest to create greater value in the long term, even if the market's eye has been distracted by shorter term news stories over the last year.

Thank you once again for your continued support and we hope that you find this letter of interest.

Best wishes



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