HollAnd Advisors

Holland Views – UK Plc

Recipe for a boom/Banking Lollapalooza

"Be fearful when others are greedy and greedy when others are fearful" **Buffett**

In the summer we used the above quote to typify the mood of UK investors and thus the resulting investment opportunities that presented themselves. Five months later we think the potential building blocks for a mini economic boom in the UK are now present. Rather than drowning ourselves in yet more political scenario painting let's start with the opportunity in UK banking shares.

UK Banking Lollapalooza

> *Charlie Munger uses the term "**Lollapalooza**" for when multiple drivers, biases, or mental models act in compound way with each other, at the same time, in the same direction creating an extreme outcome.*

We think there is a potential significant turnaround possibility in UK banking shares (plus others exposed to a UK economic recovery). Whilst our past work has been on **Lloyds** and **RBS**, we have now also looked at **Barclays** and **Bank of Ireland** – **We think all look compelling investments.** We have a simple future IRR calc for each bank giving our best guess expected returns from each. These currently suggest >20% investor IRR for these companies over the next 3 years i.e. c.100% upside. Importantly these guesstimates assume each company still ends the period on modest PE's.

NB. Whilst they are just simple extrapolations of ROE's and compounding, such models served us well in our modelling of US banking shares ahead of their 2015-7 recovery.

Why the UK banking sector looks so compelling: In short:

- The sectors starting point is one of investor hatred due to the 2008 crisis.
- Due to this the companies are not being valued off of their likely future cashflows/dividend streams.
  - UK banking valuations are backward looking – i.e. towards the crisis, thus they are valued in reference to tangible book levels.
  - The US banking sector is now rightly valued off of its earnings power.
- Protracted UK PPI costs have meant this view has become reinforced as the companies could not pay out the size of dividends that underlying profits would suggest, as the US banks now do.
  - US banks have been paying out c.100% of net income for the past 3-4 years with their regulators blessing. This was the catalyst that changed investor perceptions.
- The US sector's rise post the Trump election is the perfect example of what can happen to banking share prices if, post an election, there is a reversal in economic mood/outlook and a reduction in political risk.
- Record low interest rates convince many that Returns on Tangible Equity (ROTE) in banking will trend ever lower. However:

  - Interest rates are not an independent variable of the economic outlook – they are a circular expression of the already depressed sentiment visible elsewhere.
  - Each of the bigger UK banks has a core consumer business that currently makes c.20% ROTE even at current low interest rates. A focus on these divisions should ensure reasonable ROTE can still be made (we are only assuming 9-13% ROTE).
  - Technology is helping bigger banks be more dominant, not less due to the cost advantage of it being released over a bigger scale of customers
- Current valuations only need modest ROTE (i.e. around those already being achieved by each company on an underlying basis) to be achieved for the shares to be very attractive to equity investors
  - E.g. RBS made an underlying ROTE in 2018 of 11%. On a tangible book value per share of 276p, this results in EPS of 30p.
  - US precedents suggests there is no reason why all of this could not be paid out to shareholders and yet it represents a 13% earnings yield on today's share price (230p).
- US investors should be playing a role in buying these UK bank shares, but for now they are too fearful of Brexit and Corbyn and are not close enough to the UK grass roots to assess the real risk of either causing an economic shock. As the first (Brexit) is settled and the second (Corbyn) is defeated, and then likely is forced to resign, that outlook could change considerably and quickly.
  - On this point it is interesting to reflect the arrival of Ed Bramson, the activist, at Barclays - Having now looked more closely at Barclays we agree with his stance. I.e. the core of Barclays is a good business. Thus, it is a classic Munger 'cut out the cancer' to leave a healthy patient.
  - The UK banking sector is crying out for activists to get involved in it, but the only one is Bramson at Barclays. Maybe a Brit now based in New York has the advantage of being able to see the Brexit risk for what it is/isn't.
  - Were Barclays in any other sector there would be a queue of activists backing the Bramson view we believe. Maybe more turn up post stability in UK Plc emerging.

Politics and Economics

Clearly our assessment of the General Election outcome plays a significant role in our conviction here. **YES, IT DOES.**

- But our view is not informed by optimism (indeed the piece we wrote in January told of our fears for a Corbyn Government and the then dangerously high probability of it).
  - Our view is informed from listening to the wider population of this country in recent weeks. Many of which are now switching in large numbers from Labour party support to a Tory support due to the desire for Brexit resolution and perhaps a dawning realisation of how extreme labour policies are likely to be.
  - This is the case among both those who voted Leave AND Remain.
- The most likely outcome from the election is thus an outright, and potentially large, Conservative majority government we believe. However recent votes (Trump/Brexit/2016 election) have not gone the way of the polls so investors are loath to invest accordingly. Listening to grass roots people's views could have informed that these past actual outcomes were more likely than pollsters suggested. Such listening today produces the conviction attached to a strong Tory majority, not the opposite.
- Genuine political/economic risks are thus now reducing as Labour stands almost no chance of a majority.

  - So, the outcome is either Tory majority or less likely a coalition that backs a second referendum but agrees on almost nothing else, so maybe only lasts for long enough to reverse Brexit.
- **<u>This all suggests our favourite time to invest- i.e. When uncertainty is high, but real risk is actually lower.</u>**

Second Order thinking

Assuming a Conservative majority government is elected, what will most likely follow next?

- The swift passing of the Brexit bill with the UK leaving the EU on Jan 31st
- Whilst there will still be trade negotiations that need to take place the passing of the leave milestone, without any noticeable economic consequences, we think will cause significant relief, improve sentiment in a widespread manner (and confound many doomsters).
  - In some ways this could be compared to the fear and then relief that a surrounded the Y2K hysteria in 1999.
- More economic confidence will then be restored to the consumer and businesses <u>simultaneously.</u> Such a co-ordinated confidence recovery is a highly unusual event.
  - It should be remembered that this (were it to occur) would do so against a backdrop of ultra-low interest rates.
  - It will also be coincident with a market friendly government, but one that is fortunate enough to find itself at the point of the interest rate cycle meaning it makes sense to spend significantly on fiscal pump priming.
  - As the saying goes: *"You've never had it so good"*
- Additionally, we think the UK Labour party most likely forces Messers Corbyn and McDonnell to step down (having lost 2 elections). As a result, the party emerges as a more moderate opposition that in time could challenge the Conservatives**. However, importantly such a change again significantly reduces political/ economic risks.**
- By March the UK economy and all its participants could start to look forward rather than constantly being fearful that a political or economic banana skin is right in front of them

Animal Spirits + the UK's most loved asset, Property

- **The UK is an open, dynamic, frictionless economy** where people up and down its length and breadth want to get on with their business lives and invest to grow. It is also very property centric with highly active residential and commercial sectors. The currently very depressed 5-10y interest rates have not created the activity in this and related sectors they normally would because of the prolonged Brexit uncertainty. A recovery in confidence and record low interest rates combined with the factors described above could well create an accelerated rise in property values, further re-building wider economic sentiment.
- We note the difference with a country like Germany where this interest rate arbitrage is not as immediate due to issues like efforts to regulate Berlin rental prices.
- For better or worse, the UK economy is closely linked to asset values and interest rates. On occasions this can cause it trouble, but right now it could be its saviour – at least for a while.
- We attached a number of our past pieces which hopefully cover such areas as:
  - Why the UK banking sector has been hated/Why value investors are forced sellers of such shares
  - Why the London elite were struggling to understand that Brexit would not be an economic problem.

- Why the UK economy is destined to be far more closely aligned with that of the US, rather than Europe (see attached charts). Importantly UK interest rates imply the opposite.

Risk

As an aside we think this insight into the chances of a Labour majority from one of the UK's most respected pollsters is insightful as to the downside risk in such an idea.

> *"The chances of the Labour Party winning a majority are frankly as close to zero as one can safely say it to be given, they look utterly incapable of regaining anything in Scotland."*
>
> "*The problem the Labour Party has is they've tried to satisfy everybody and have ended up satisfying nobody* **Professor Sir John Curtice**

https://politicshome.com/news/uk/political-parties/labour-party/news/107986/chances-labour-majority-almost-zero-claims

In Summary

Anthony Bolton once said that if you are waiting for the last piece of the jigsaw it will be too late. A majority Tory Government we think is becoming a most (even very) likely scenario as the UK election result. Were that to be the case it will start a chain of events which could potentially see strong recoveries in sentiment, business activity, property prices and ultimately interest rates. Whilst there are numerous sectors that will benefit from such an outcome the UK domestic focused biggest bank we think are perfectly placed to do so more than any other. A Munger like Lollapalooza outcome looks possible.

"When it is raining gold reach for a bucket not a thimble" **Buffett**

Please do look at our past work on all these related areas attached.

With kind regards

Andrew and Mark **firstname@hollandadvisors.co.uk**

Contact:

HollAnd Advisors

Holland Advisors London Limited
2nd Floor, Berkeley Square House
London
W1J6BD

Tel: (0)871 222 5521
Mob: (0)7775 826863
www.hollandadvisors.co.uk