

Polar Capital Global Financials Trust

Banks too cheap to ignore

US rate cuts and a slowing global economy have overshadowed the financials sector and banks in particular so far this year. With banks trading close to multi-year lows, Polar Capital Global Financial (PCFT)'s managers have been adding to positions in their favoured stocks.

The managers believe that banks boast far more robust balance sheets and much healthier lending exposures than they did a decade ago. PCFT's managers feel that, barring the deepest of recessions, banks are materially undervalued. Any positive shift in sentiment, could trigger a rerating in what remains the largest sector in most indices.

For a UK-based investor, PCFT offers a much more diverse exposure to the financials sector than an investment in those banks listed in the UK. Since launch, it has also delivered returns well ahead of those stocks (see page 8), while paying out an attractive yield.

Growing income from financials stocks

PCFT aims to generate a growing dividend income, together with capital appreciation. It invests primarily in a global portfolio, consisting of listed or quoted securities issued by companies in the financial sector. This includes banks, life and non-life insurance companies, asset managers, stock exchanges, speciality lenders and fintech companies, as well as property and other related sub-sectors.

Year ended	Share price total return (%)	NAV ¹ total return (%)	Benchmark total return ² (%)	MSCI AC World total return (%)
30/09/15	3.6	5.0	0.6	(0.1)
30/09/16	4.4	14.1	19.4	30.6
30/09/17	37.3	24.1	23.7	14.9
30/09/18	3.5	3.4	4.9	12.9
30/09/19	5.3	5.3	8.1	7.3

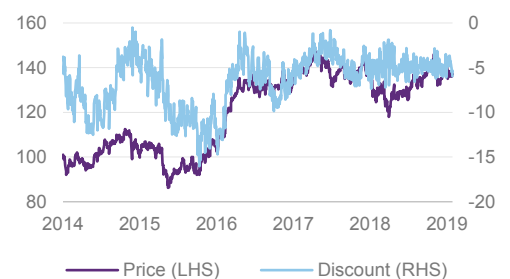
Source: Morningstar, Polar Capital, Marten & Co. Note 1) see page 7 for details of returns generated by the managers on the whole portfolio. Note 2) PCFT's benchmark is the MSCI World Index Financials plus Real Estate Index (see note on page 9)

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Sector	Specialist - financials
Ticker	PCFT LN
Base currency	GBP
Price	137.0p
NAV	145.7p
Premium/(discount)	(6.0%)
Yield	3.1%

Share price and discount

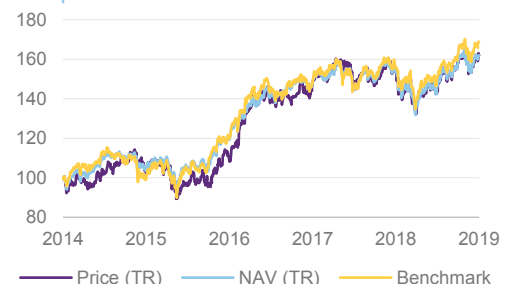
Time period 30/09/2014 to 25/10/2019



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/09/2014 to 30/09/2019



Source: Morningstar, Marten & Co

Domicile	England & Wales
Inception date	1 July 2013
Manager	Nick Brind and John Yakas
Market cap	277.8m
Shares outstanding	202.775m
Daily vol. (1-yr. avg.)	414,205 shares
Net cash	0.5%

[Click here for our initiation note](#)

A sector out of favour

Readers may find it useful to refer to [our initiation note](#), which has more information on the investment process

PCFT's NAV and share price have made modest gains since we published our initiation note at the end of April 2019, but its managers say that the sector remains out of favour with investors.

Notwithstanding the progress that share prices have made in 2019, many banks around the world are trading close to valuation lows. The volte-face in Fed policy at the turn of the year has now manifested in two quarter point rate cuts and there is talk of more to come. Investors appear to be worried about the impact on bank's margins. They may also be concerned that we are approaching the end of a decade-long period of economic growth and, by implication, an uptick in defaults. The managers think that the sharp moves in valuations that we saw at the end of the fourth quarter of 2018 may provide an indication of where the market sees potential problems. Credit spreads widened and high-yield and structured credit were hit quite badly.

“even a shallow recession would make the sector look cheap”

The managers say that there have been outflows from the sector and this has impacted on its performance relative to wider markets. The sector's long-term underperformance has occurred despite it offering a yield premium to market averages. The managers think that so much bad news is discounted in valuations now, even a shallow recession would make the sector look cheap.

Figure 1: MSCI World Financials plus Real Estate



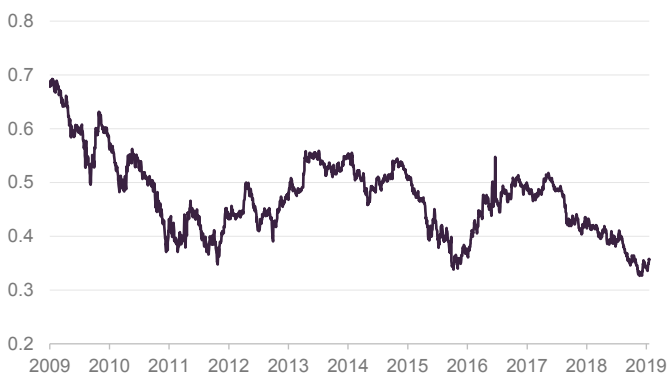
Source: Bloomberg, Marten & Co

Figure 2: MSCI World Financials plus Real Estate relative to MSCI AC World



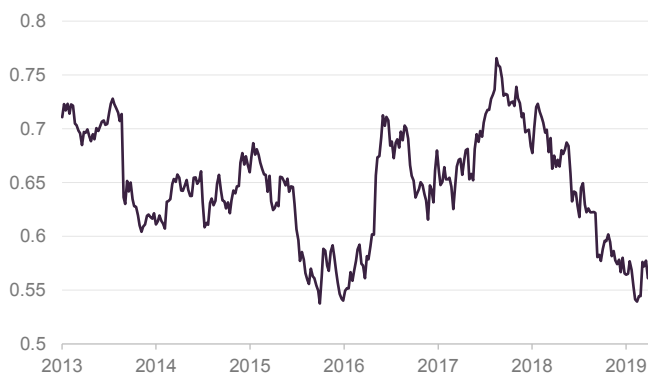
Source: Morningstar, Bloomberg, Marten & Co

Figure 3: EU banks p/b relative to STOXX



Source: Bloomberg, Marten & Co

Figure 4: US banks p/e relative to S&P500



Source: Bloomberg, Marten & Co

Margins improving

\$17trn of debt on negative yields and interest rates falling

The actions of central banks, not just the Fed and the ECB but in many other places, have depressed interest rates to new lows. Around \$17trn worth of debt is said to be trading on negative yields. Last year, the Fed made an attempt to reverse QE and raise interest rates but has backtracked in 2019. In September, outgoing ECB chairman Mario Draghi cut rates again and restarted the ECB’s bond buying programme, despite some public opposition to this move from the heads of a number of European central banks. Growth fears, negative rates and concerns over Brexit mean that European banks are trading at low multiples, as is evident in Figure 3.

Banks are still making money on their lending

Some investors reason that ultra-low rates wipe out bank margins and, as Figure 5 shows, this manifests itself in a strong correlation between the performance of banks and government bond yields (a chart of European banks against 10-year bunds would show a similar story). However, while deposit margins have been hit, banks are still making money on lending. Large loans are more price-sensitive but, in practice, banks are reducing their balance sheet risk by either sponsoring bond issuance by mid-large corporates (and earning placing fees), syndicating loans (again earning fees) or underwriting leveraged loans that are then securitised (many ending up in CLOs).

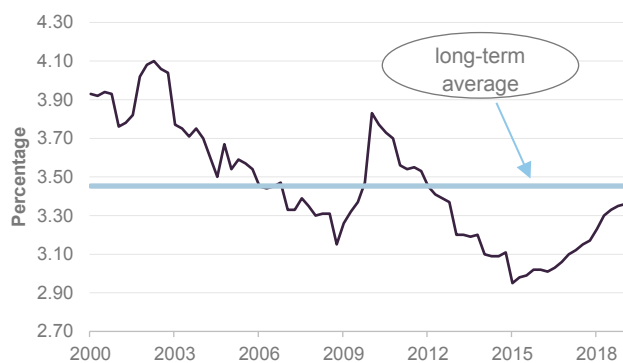
Overall, US margins are higher than they were five years ago. We used the chart in Figure 6 in our initiation note but have updated the figures to include Q1 and Q2 2019 numbers; margins appear to be climbing.

Figure 5: US banks relative to S&P 500 compared to yield on 10-year Treasuries



Source: Bloomberg, Marten & Co

Figure 6: US Bank net interest margin (quarterly)



Source: Federal Reserve Bank of St. Louis, October 16, 2019

For example, one area where banks appear to have been raising margins is credit cards. This is profitable business for most banks.

Figure 7: Average credit card rates – US banks



Source: Federal Reserve Bank of St. Louis, October 16, 2019

Default risk overstated?

With respect to the end of the credit cycle and the risk of defaults, the managers reiterate the points we made in our initiation note. Regulatory requirements and the need to repair balance sheets have constrained bank lending. There is an argument that regulation has become overly prescriptive, with the prospect of positive share price moves if the rules are relaxed.

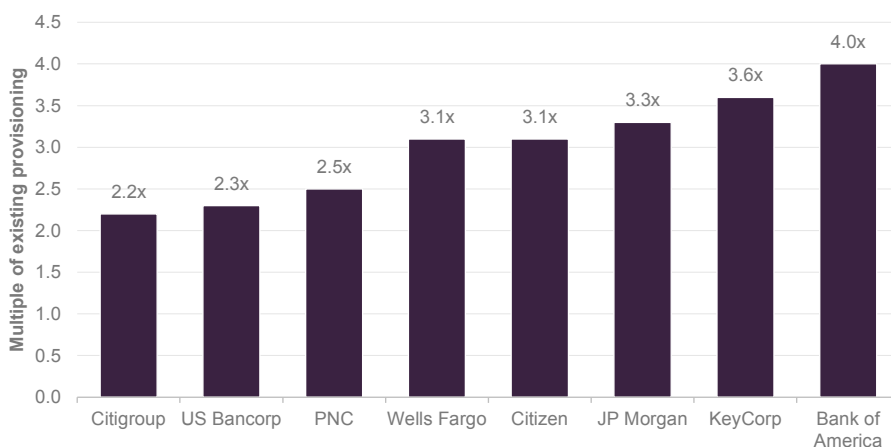
The leveraged loan market and alternative lenders have fuelled recent lending growth

In the meantime, alternative lenders have taken up the slack and it is these alternative lenders who will bear the brunt of higher defaults should they arise. The explosive growth of the leveraged loan market, supported by securitisations, has been accompanied by a relaxation of covenants and an increase in leverage multiples. In the direct lending sector, the likes of Funding Circle and Lending Club, appear to be seeing rising default rates already.

Banks' ratings do not reflect the relative strength of their balance sheets

Generally, banks have been cautious on lending to the commercial property sector and have been keeping corporate bond exposure low. Banks' balance sheets are in good shape, therefore. However, investors do not appear to be ascribing any premium for this in bank's ratings. In fact, PCFT's managers are convinced that the market is pricing in a material deterioration in asset quality. Figure 8 shows the increase in provisioning that would justify the managers' estimates of fair value for a range of banks.

Figure 8: Implied provision increase for fair value



Source: Polar Capital, Bloomberg, data as at September 2019

In addition, low interest rates and debt repayments have reduced the debt-servicing burden on US households.

Figure 9: Household debt service and principal payments, percent. of income



Source: Board of Governors of the Federal Reserve System (US), October 23, 2019

Nevertheless, the managers are conscious that stock specific risk is an issue in the sector and the opacity of many banks' business models makes it hard to know where contagion might arise. This is one reason why they seek to maintain a diversified portfolio.

Banks are adapting in the face of fintech

The fintech sector is a mixed bag. Some of these business models may be very successful but most incumbent banks recognise the threat of disruption and are attempting to adapt. High Street banks are still being rationalised, the managers believe that there is more to do on this front. Branch staff are being retrained to focus on sales but many banks do not appear to be radical enough on addressing their property overheads. Nevertheless, many challenger banks are struggling to procure profitable business and are not yet impacting on established lenders.

M&A activity is a natural response to the threat of fintech

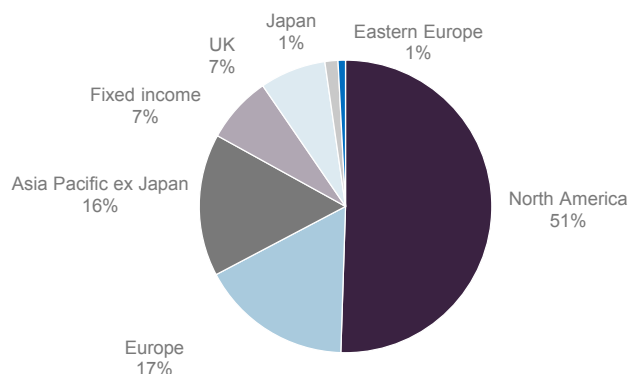
The need to invest in new technology and the costs associated with that are drivers of M&A, as banks try to benefit from economies of scale. The managers say that if there is overlap between two businesses, it is possible to take out as much as 80% of the cost base. Falling valuations in the sector may help encourage further M&A.

Outside of banking, payments companies are doing well. Mastercard has been a strong performer within the portfolio. However, the managers would still highlight the valuation gap between it and the new entrants to the sector. Square (which is not held within PCFT) has been a volatile stock and has not made headway this year. Nevertheless, it still trades on a significant premium to Mastercard.

Asset allocation

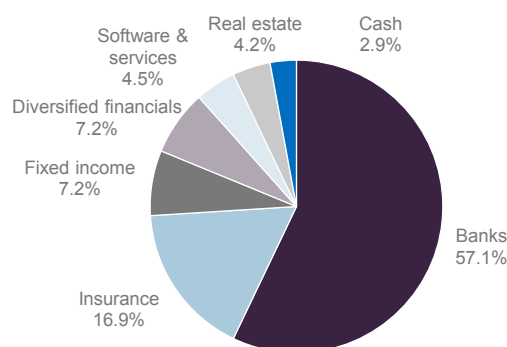
At the end of September 2019, there were 65 positions in PCFT's portfolio, six fewer than the number at the end of March 2019 (the data we used for our initiation note).

Figure 10: Asset allocation by country as at 30 September 2019



Source: Polar Capital Global Financials Trust

Figure 11: Asset allocation by sector as at 30 September 2019



Source: Polar Capital Global Financials Trust

Gearing is being kept low

Generally, the managers are quite cautious and for that reason are keeping gearing low. The portfolio retains its US and banking biases. The managers reiterate that diversifiers such as the small/mid cap US banks can offer superior growth and the prospect of M&A activity. Although, for the time being, the US banks have been held back by the shift in sentiment triggered by falling US interest rates.

Increased exposure to the insurance sector

The managers have been adding to PCFT's exposure to insurance. The managers cite evidence such as the Barclays Pricing Survey (which looks at pricing trends within the commercial property and casualty market) to support a belief that insurance premiums are firming. On a price-to-book basis, insurance companies are trading close to long-term averages. Recent purchases include the Bermuda-based, Arch Capital and AIA, the Asia and life assurance focused business based in Hong Kong.

Elsewhere in Asia, the exposure to Japan has been trimmed as has PCFT's exposure to Singapore REITs.

PCFT's Indian private banks have been beneficiaries of India's liquidity crisis (manifested especially within its housing finance companies, but exacerbated by its failure to resolve the non-performing loan problem within its public banks). The portfolio has never had exposure to Chinese banks and overall exposure to China is relatively low. The businesses they favour are high-quality companies with strong franchises.

Top 10 holdings

Figure 12: Top 10 holdings as at 30 September 2019

	Country/Region	Subsector	% of gross assets 30/09/19	% of gross assets 31/03/19	% change
JPMorgan	United States	Banks	6.0	5.1	0.9
Bank of America	United States	Banks	4.0	3.7	0.3
Chubb	United States	Insurance	3.6	3.1	0.5
Mastercard	United States	Speciality finance	3.5	3.1	0.4
Arch Capital	Bermuda	Insurance	3.3	2.4	0.9
Citizens Financial	United States	Banks	2.6	1.8	0.8
Wells Fargo	United States	Banks	2.5	2.0	0.5
Toronto-Dominion	Canada	Banks	2.4	2.1	0.3
Marsh & McLennan	United States	Insurance	2.4	2.2	0.2
US Bancorp	United States	Banks	2.3	1.9	0.4
Total of top 10			32.6		

Source: Polar Capital Global Financials Trust, Marten & Co

The composition of the top 10 holdings has not changed much over the past six months, as one might expect, given the managers' investment style. While it is still reasonably diversified, the portfolio has become more concentrated in fewer names, with the top 10 accounting for 32.6% of the portfolio at the end of September 2019 against 28.4% at the end of March 2019.

The managers have taken advantage of weakness associated with US rate cuts to add to positions such as JPMorgan and Citizens Financials. Mastercard has been performing well. We mentioned the increased holding in Arch Capital above. Wells Fargo's share price has been climbing as it recovers from the fallout of a series of scandals, including the creation of fake accounts and mis-selling. A change in CEO also helped sentiment towards the bank.

Performance

PCFT lagged its benchmark by a small margin over the six months ended 30 September 2019 (the period since we last published). In part, this reflects the poor performance of banks relative to other constituents of the financials and real estate index. The extent of the benchmark's underperformance relative to the MSCI AC World Index over the past five years is clear from Figure 13, illustrating how out of favour the sector has been with investors.

Figure 13: Cumulative total return performance over periods ending 30 September 2019

Heading	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
PCFT price	3.7	2.1	13.0	5.3	49.7	61.9
PCFT NAV	3.3	2.9	11.3	5.3	35.1	61.9
PCFT portfolio NAV ¹	3.3	2.9	11.3	5.3	39.2	67.7
MSCI World Financials plus Real Estate	3.5	4.3	12.6	8.1	40.3	68.7
MSCI AC World Index	0.9	3.3	9.5	7.3	39.2	81.5

Source: Morningstar, Polar Capital, Marten & Co. Note 1) this data has been sourced from the manager.

When PCFT was launched, investors were given subscription shares alongside their ordinary shares. Holders of subscription shares had the right to buy one ordinary share at a price of 115p on 31 July 2017 for each subscription share that they held. The effect was that, as PCFT's NAV rose above 115p, returns to ordinary shareholders were diluted. The portfolio NAV (or undiluted NAV) shows the returns that the managers actually generated and represents the return that an investor who held onto their subscription shares and exercised them would have received. For periods beginning after 31 July 2017 the NAV and portfolio NAV returns are identical.

Figure 14: PCFT NAV total return and portfolio NAV total return¹ performance relative to benchmark²



Source: Morningstar, Polar Capital, Marten & Co. Note 1) Portfolio NAV is defined above and reflects the performance achieved by the managers. This data has been sourced from the managers. 2) PCFT's benchmark is the MSCI World Index Financials plus Real Estate Index (see note on page 9)

PCFT's share price returns are ahead of those of the benchmark over the past six months, reflecting a welcome narrowing of its discount.

Up-to-date information on PCFT is available on the [QuotedData website](#)

PCFT has outperformed UK banks by some margin

A key argument behind the launch of PCFT in 2013 was that it would provide UK-based investors a lower risk exposure to the financial sector. The UK banks have lagged PCFT's NAV returns by some margin since then as is evident in Figure 15. The UK economy has influenced this to some extent, but many of these banks operate globally.

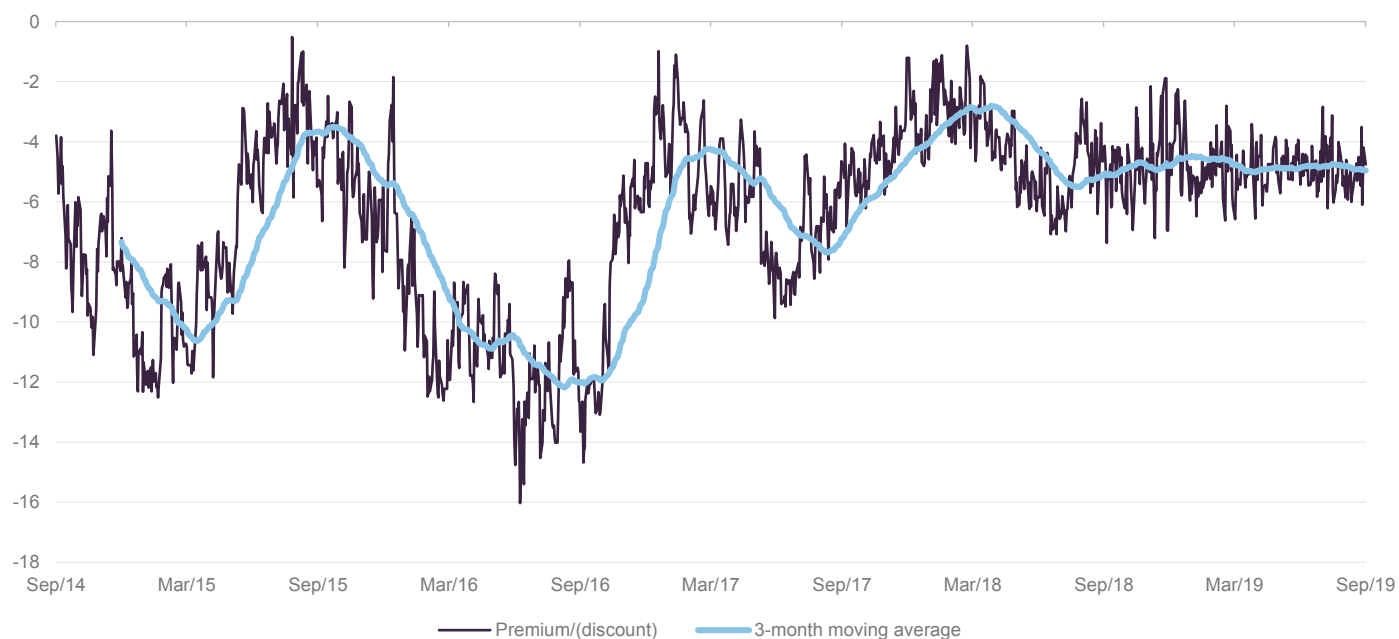
Figure 15: Cumulative performance to end September 2019

	1 year (%)	3 years (%)	Since PCFT launch in July 2013
Polar Capital Global Financials NAV	5.3	35.1	77.5
Polar Capital Global Financials portfolio NAV	5.3	39.2	83.9
Barclays	(0.7)	28.5	31.3
HSBC Holdings	(3.4)	15.6	6.5
Lloyds Banking Group	(6.4)	31.9	(13.8)
Royal Bank of Scotland	(8.5)	(2.9)	(30.9)
Standard Chartered	10.5	13.8	(41.6)

Source: Bloomberg, Morningstar, Marten & Co

Discount

Figure 16: PCFT's discount (based on the diluted NAV) over the five years to 30 September 2019



Source: Morningstar, Marten & Co

Over the year to the end of September 2019, PCFT's discount has moved within a range of 7.4% to 1.8% and has traded at an average of 4.8%. At 25 October 2019, the discount was 6.0%. Reflecting the small narrowing of the discount achieved over the

past six months and the relatively low volatility of the discount, no shares have been bought back since we last published on the company but the board does have the ability to do this should the need arise.

Fund profile

PCFT looks to grow investors income and their capital

More information on the trust is available on its website

www.polarcapitalglobalfinancialstrust.com

Reconstituted benchmark

Polar Capital Global Financials Trust (PCFT) launched on 1 July 2013 and has a fixed life that expires in May 2020. Its twin objectives focus on growing investors' income and their capital. Its global mandate makes it a useful alternative for UK-based investors looking to diversify their financials exposure.

Predominantly, the portfolio is invested in listed/quoted securities. The trust may have some exposure to unlisted/unquoted securities, but this is not expected to exceed 10% of total assets at the time of investment.

The trust was benchmarked against the MSCI World Financials Index from launch until 31 August 2016. Then, when MSCI spun the Real Estate sector out of the Financials index, the benchmark became the MSCI World Financials plus Real Estate Net Total Return Index (in Sterling) – effectively a continuation of the pre-September 2016 benchmark.

PCFT's AIFM is Polar Capital LLP and the lead managers are Nick Brind and John Yakas.

Previous publications

Marten & Co published its initiation note on PCFT, *[Don't fear a slowing economy](#)*, on 30 April 2019. You can read this by clicking the link or by visiting the martenandco.com website.

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