VT DE LISLE AMERICA FUND

Research Note

Fund Manager Richard de Lisle

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For Professional Advisers Only

Community Banks

Community banks have long been the epitome of the steady growth stock, typically having an underlying trend earnings growth rate of 10% going on for decades. With a reasonable dividend and stock buybacks they have been a long-term outperforming group. The single statistic which originally attracted me is that low-beta is an outperforming category and this is one of the lowest beta groups in the market. Sadly, all these long-term statistics were turned upside down from 2017 until 2020. We've been overweight since 2013.

2020 Election and Biden's Presidency

In November 2016 Trump had a surprise victory with the slogan 'Make America Great Again' and his red states were the landlocked heartlands. His support cohorts were middle income whites who were hoping for infrastructure spending to reverse their relative decline. This would have helped small businesses and hence small banks and for two months our banks rose in anticipation. Then came four years of falling growth and falling inflation with tariffs being the only policy initiative that are also deflationary.

Growth slowed to such an extent there was a recession scare in December 2018 and a full stop to the economy in March 2020, all of which was not beneficial for our banks because the yield curve became flatter and margins got thinner and thinner. Banks kept on coming through with the goods and growing earnings, so we didn't lighten at the time. The market just let them drift to cheaper and cheaper ratings. Ironically, Trump's rival Biden has made pledges to do what middle-America had hoped would have happened in 2016. Now there are even more holes in the road and the stimulus will be felt even more.

Macro Landscape & Yields

A key figure for a bank is its Net Interest Margin (NIM) which is the spread between average deposits and average loans. As the yield curve flattens, the spread gets narrower and bank stocks underperform on anticipation of falling earnings.

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From 2017 to 2020, weak growth meant the Fed was easing and short-term rates headed to zero. By September 2019, $17 trillion or a third of sovereign debt in the world had a negative yield and long term rates were little more than 1% and these figures were still the same in September 2020.

All policy to stimulate the economy was done through monetary policy but if there were no longer any interest rates, how could banks make any reasonable spread at all? At its worst there was an argument that by paying depositors zero, banks were squeezing themselves because zero was too high a rate to pay! Finally, the conventional wisdom that monetary policy will do it has been abandoned and today the Keynesian view that zero rates are no better than pushing on a piece of string has been resurrected and called Modern Monetary Theory (MMT) to placate the Americans that they have thought of something new. Today Fiscal policy is back in order to revive the economy at all costs and the forthcoming deficit spending, like the $1.9 trillion stimulus package, has already got the yield curve the steepest in two years.

Big Banks Vs. Community Banks

Today, in early June, we are still in a situation where community banks are catching up. They're doing well and have been the best group except for energy since vaccine day, last November 9th, but we want to see more. If anything, our banks have reported better earnings than their big brothers as they were able to get closer to their customers by administrating government loans and helping local businesses in the crisis. Community banks reported up earnings in 2020, regionals and money centres (the two bigger classes of banks) did not. On top of that, we are now looking forward to an ideal environment for banks to increase profits. Firstly, we have the fastest real GNP growth since 1973 in prospect, variously argued to be around 6.8% going forward. Secondly, those conservative loss provisions which didn't materialise are still being written back in. Nevertheless, we still have some banks which have not yet popped out to new highs and generally speaking our banks are still cheaper than in past good times. For instance, as a group our banks are currently trading on 1.1x tangible book value. This is above when they were selling at discounts because people thought they would take hits, but it remains below the 1.5x we have seen as recently as 2017. Expect our Fund to remain surprisingly strong relatively as this ratio normalises. We have 32% in this group, which is a little down from the peak as I have been putting new funds into various different areas and the whole fund has been going up well this year. Even when they're going up, this group can slow us down if we're racing because they're a very low beta group.

We've had quite a few triumphs among our smaller holdings this year. Customers Bancorp has doubled after administering huge numbers of PPPs, Select Bancorp received a takeover bid, Ameris and Central Pacific (it's in Hawaii in the centre of the Pacific!) are up 50% which is better than the overall Fund which is up a third.

However, it is interesting that the best triumphs remain in our larger banks. For this reason, all these months later, our tiny banks are still playing catch-up and we fully expect them to come trotting along bringing up the rear. This is reinforced by the simple points that they remain much cheaper and this cheapness differential with their larger counterparts remains wide on an historic basis.

An important one is F S Bancorp, our largest holding. We've gone from $17.35 to $71 in 6 years and for a long time we were the only institutional holder. Today we don't even make the list of top holders. I feel this one should go to $100 to be correctly re-aligned because trailing 12 months earnings are $8.97 so even here it is just on 8x earnings. If it did the impact on the Fund would be significant.

Past performance is not a guide to future performance; the value of an investment and income from it can go down as well as up.