AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive

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Australian Banks and the *Widow-Maker* Trade?

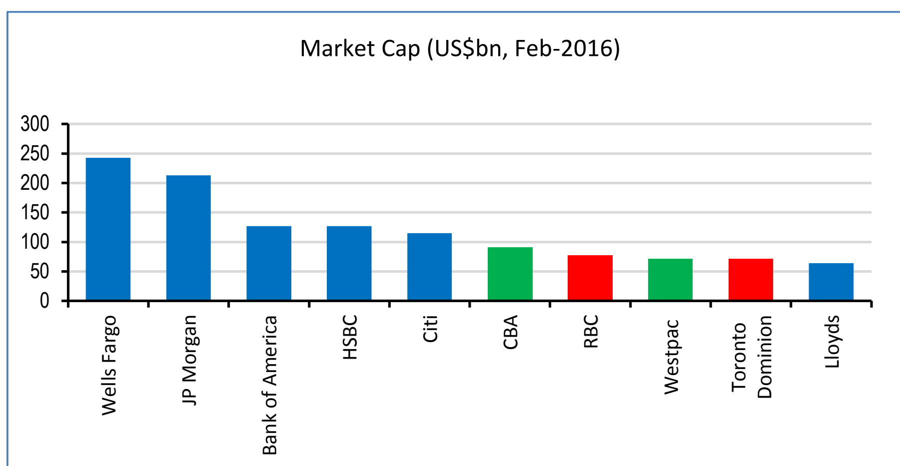
On Monday a Swiss friend was bemoaning the dramatic fall in the share prices of ***Credit Suisse*** and ***UBS***. Indeed in terms of market cap UBS, CS and Deutsche Bank combined were worth slightly more than ***Commonwealth Bank***. Despite working in finance, the Swiss friend has not heard of this Australian bank.

Probably the biggest question that any Australian equity fund manager faces is what weight in a portfolio to allocate to the banks. Over the past few years, the Australian banking sector has grown to represent 31% of the ASX100 on the back of record bank profits, weakness in other sectors and a chase for yield by investors globally as monetary policy settings across Europe, Japan and the US have pushed interest rates to multi-century lows. All of this has contributed to all 4 of the Australian banks now being in the top 15 banks globally by market capitalisation, despite their relative lack of importance in the global financial system. In this week's piece we are going to look at the change in banks over time.

The Widow-Maker Trade?

Also yesterday I asked a managing director at a large US investment bank visiting from New York how the Australian banks are viewed by US fund managers. He responded that *"they are viewed as the "Widow-maker" trade, bro!"*. A "*Widow maker*" trade in the hedge fund world is a short sell trade of an over-valued asset that may sense intellectually, but as it continues to rise, the short seller is forced to post ever increasing amounts of cash into their margin account, increasing the chance that the fund manager has a heart attack or gets fired. A classic widow-maker trade recently has been shorting Japanese government debt, as deteriorating government finances were paradoxically accompanied by even lower interest rates on Japanese debt.

Here US fund managers have been systematically shorting the Australian banks based on a seductive story that due to relative over-valuation, the Australian housing market is primed for a dramatic decline as occurred in Ireland, US and Spain over the past 10 years. The basis of their thesis is that four banks from a small backwater in the financial world have little business being amongst the largest in the world. They believe that a slowing domestic economy will burst the housing bubble, thus allowing the Australian banks (and their shareholders) to endure the same pain and losses experienced in the US and Europe.



Despite the 20% fall in both the AUD and Canadian dollar over the past two years, two of the largest ten banks globally by market cap are domestically focused Australian banks with a significant exposure to housing. NAB and ANZ are lurking just outside the top ten by market capitalization and ahead of such well-known names of Barclays, Credit Suisse and Suimitumo Mitsui. Interestingly the top banks by market capitalisation also include Canadian banks (coloured in red) such as RBC and Toronto Dominion whose earnings are driven by domestic mortgages in cozy oligopolies that are not globally significant banks.

A look back in Time

Looking back at the lists of the largest banks in 2005, 1995 and 1985; the banks that dominated these lists have generally been very poor performers in the following decade. In the early 1980s four of the top 10 banks were French, all of which were later nationalised by the Mitterrand government.

By 1995 the French banks had all fallen off the list, which was now dominated by Japanese Banks like Sumitunmo Mitsui, Nomura and Daiwa. These banks were viewed at the time to be taking over the world as Japanese investors bought up assets from the Rockefeller Centre to Gold Coast apartment blocks. The bursting of the over-heated Japanese asset price bubble resulted in a massive amount of non-performing loans and the failure of several Japanese banks.

The chart below on the right shows the list of the top banks by size as of December 2005. The list was dominated by US and European banks, as investors wanted exposure to innovative banks whose expertise at structuring complex financial products seemed to generate a stream of very strong profits with minimal risk. The financial crisis 2007-08 brought on by the bursting of the US housing bubble was very unkind to these banks, with the bulk of them being forced to seek state bail-out packages to ensure their solvency. Indeed the largest bank on the list, Citibank, has a share price that currently sits -90% below what it was in December 2003 thanks to a dilutionary bail out that saw the US taxpayer take a 36% equity stake in the bank.

What happens next?

Looking back through the past owning the largest and most loved banks in 1985, 1995 and 2005 subsequently proved to be a poor investment decision in the following decade, so logically why wouldn't owning Australian and Canadian banks result in tears for investors over the next decade. Last year during the October reporting season we posed the question to one of the CFOs of a major bank. His response was that the positioning of the Australian and Canadian banks at the top of the list of global banks has more to do with the collapses in value of the European and American banks and the relatively low levels of losses incurred by the Australian banks during the aftermath of the GFC and the lack of fines levied[1], than any world-conquering strategy.

[1] Twenty of the world's biggest banks have paid more than US$235bn in fines and compensation in the last seven years for breaching a variety of financial regulations. Australian banks have been absent from this list of miscreants.

Our Thoughts

The Australian banks have been very successful over the past few years in generating record profits from their domestic franchises which operate in a cozy banking oligopoly. Competition from non-bank lenders has decreased along with bad debts which are now at historically low levels. What caused the French banks, Japanese and US to blow up in the late 1980s, 1990s and 2000s was rapid lending expansion into new areas that in hindsight their management teams did not fully understand. The bulk of the lending growth being delivered by the Australian banks is being done domestically in areas where the banks generally have a strong history of profitable business.

Whilst Australian housing can be viewed as expensive globally, we see a range of factors that strongly encourage Australian households to maintain mortgage payments. These include recourse lending, homes are exempt from no capital gains tax and strong cultural desire to own one's own home.

Nevertheless Australian banks (whilst offering high dividend yields) are likely to face a pretty constrained environment and higher loan losses should the economy continue to slow. Neverthe on the results we have seen over the past two weeks from CBA and trading updates from NAB, ANZ and Westpac, our domestic banks are still very profitable and are still recording very low levels of bad debts. Indeed on Tuesday NAB recorded their lowest bad debt charge since 1980!

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