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EP 171 | Banks Around the World: What Makes Top Financial Institutions Stand Out

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[00:00:21] Andrew Johnson: Hi everyone. In today's episode, we're taking a bit of a different approach. We're going to go around the world, exploring the countries where we invest in bank stocks. Recently, I had the chance to sit down with some of our portfolio managers and analysts to discuss how we view banks and the industry trends, as well as local dynamics, and ultimately what makes each of these businesses both unique and attractive. Our goal here is to provide you with what we fundamentally look for in a bank as an investment. That stands in contrast to say, making a call on when these banks are good investments. Currently, we're in the middle of a very favorable period for banks. Interest rates are higher than they've been in recent history. Credit losses have stayed within their normal ranges and the hope for a soft landing is currently still alive. Banks have seen strong profitability in this environment. What we do believe has staying power is the enduring nature of our investment philosophy that focuses on strong business models, excellent management teams, and paying very close attention to the price that we pay for these stocks. By sticking with this approach, we can build in a margin of safety that can help navigate the inevitable cycles that either the market or the economy will bring, whether it's for banks or any other business models for that matter. Let's get started with David Ragan sharing insights on what we're looking for from a high level and some observations on the Scandinavian banking sector.

[00:01:43] David Ragan: Fundamentally, when we're looking for a bank, the core thing you want to look for is a bank that will lend to people and institutions that will pay them back. In a highly levered business model, a small problem can become very large very quickly. Then hopefully these banks have the opportunity to add on additional services to their clients who become increasingly locked in and profitable. You have to have the perception of being strong, being viable every day of the year, every minute of the year. I've seen many examples of a bank that showed even a small bit of weakness and suddenly became insolvent. Depositors and fixed income managers who lend the bank money are very quick to leave. Even the perception of weakness can mean the end of a bank. Depositors and fixed income managers who lend the bank money are very quick to depart at the first sign of problems. The downside is very large for them and the upside is small. So even the smallest hint of difficulties or the potential difficulties can mean a run on the bank and its liquidation. We also like to see things like a concentrated industry where there's a few banks with large concentrations and who's writing the mortgages, who has the deposits. Competition is fairly rational. The regulators are also rational. They have to understand that while they have to keep banks in check, the best interest of the country is a well-functioning financial system that is really the lubrication of the whole economy. Finally, diversification—diversification of who you lend to, diversification of who you borrow from, diversification of the economy is ideal. It's harder to take down a bank if it's truly diversified.

We own two Scandinavian banks. The Scandinavian region does offer, I think, a better banking environment where there's smaller populations, so not a big, attractive market like some. Banking is relatively consolidated, and regulators seem reasonable. There is a unique regulator for both the core markets of Sweden and Norway,

the home of the two banks I'll talk about. Handelsbanken is the first, and it's based in Sweden. This is a bank that really does focus on smart lending. It literally wrote the book on better banking. It's called "A Blueprint for Better Banking." It highlights how they're focused on lending to customers who will pay them back, being very bottom up, where the branch manager has a lot more discretion in understanding the customers and who to take the credit risk on and who not to. This bank has a long history of reasonable returns. We don't think they're over-earning, nor are they seeing the big gaps down that some banks and other jurisdictions that are more problematic see. It's a lot more stable, good levels of loan loss and moderate growth. Another bank that we introduced into the international equity strategy more recently would be DNB Bank. This one is based in Norway. Norway is a 5.5 million population country, so a smaller market, a unique language. It is consolidated, with DNB being the largest entity there, running about a third of the mortgages, having a good portion of the deposits. All these characteristics lead us to really like DNB and explains why it's got an attractive return on equity (ROE). It's 10 to 15%, usually a little bit higher in that range. Again, the stability, which is very important to us, very stable in terms of loan losses. We think they're really focusing on the right thing in lending to people. The economy is strong. It is oil- and gas-focused, but Norway also has a massive sovereign wealth fund that is a good buffer to some of the economic ups and downs that the country might see. While our universe in the international equity strategy has a lot of banks, a lot of countries that have a lot of large banks, we're not in most of them because they don't exhibit the same sort of characteristics that we see in the likes of Handelsbanken and DNB, where it's just a better market, it's more stability, more rational competition. We're not there. We're up in Scandinavia.

[00:05:30] Andrew Johnson: From Scandinavia, let's head over to Singapore and talk with Josh Samuel for some more insight on banks and in particular, Singapore's powerhouse, DBS.

[00:05:38] Joshua Samuel: I'm going to walk us through how does Mawer look at banks? When you think of our investment process, we buy wealth-creating businesses run by excellent management teams at a discount to intrinsic value. In the context of banks, what does wealth creation mean? Before I dive into the details of DBS, which I'm going to talk about later, I think it's helpful for me to share a key formula that will help drive this discussion. If you refer to this screen here, the return on equity of a bank is equivalent to the return on asset (ROA) multiplied by asset leverage. Asset leverage is basically inherent in the business model of a bank because banks take in deposits and they lend deposits out to the customers. There is equity capital, which we are investing in, that functions as a buffer of sorts for the depositors, if not all your depositors in the banks won't be able to sleep well at night knowing that they've underwritten all the credit risk in the loan book. When it comes to how does a bank generate ROE in excess of its cost of capital, the key lever that we are focused on is really the ROA piece here, because asset leverage is just loans over equity capital. If you lever up too high, it's actually more risky. If I dissect this ROE into what is it made of— ROA, I mean—ROA is a function of your net interest margins and your fee income yield on assets. All these numbers I'm writing here have a denominator of the asset base or loan to simplify it. So net income margins plus fee yield, we minus OpEx intensity, and we minus off your credit costs. When we look at banks, what we're really trying to understand is, do any of our banks have an edge in any of these key drivers of ROA? Before I dive into DBS, I can just give you an example. Fintech companies, for example, are probably better suited on the credit cost side because they have better data, which allows them to underwrite better. They have probably have an edge in lowering credit costs. For today's discussion, since I'm going to be talking about DBS, I'm going to really focus on the NIM portion. NIM is really your net interest income minus your cost of funds (COF). When it comes to banking franchises, strong banking franchises typically have very low cost of funds. This brings us to the discussion on DBS. DBS is the largest bank in Singapore, a household name. In Singapore, the top three banks have 70% of the market share. What happens is that DBS and its two other Singaporean peers actually have access to a very low cost of funds. This in turn, if you can see this

equation, when you have access to low cost of funds by having a high mix of current account and savings accounts, this means that your NIMs are advantaged, which in turn leads to higher ROA and ultimately a higher ROE.

This really brings me to this discussion on DBS, DBS being the largest deposit franchise in Singapore. They own the POSB (Post Office Savings Bank) franchise, which is, you can think of it as the de facto, you'll say national bank in Singapore, since the start of the country. Everybody's salaries—at least from 20 or 30 years ago—everybody's salaries gets credited into debt. This means DBS has the highest CASA (current account and savings account) rate in Singapore. What does this mean? In simple terms, it just means that your CASA deposits pay up 50 bps or 0.5% interest in an environment where the short-term rates are about 3 to 3.5%. For context, interest rates going from basically 0 to 3.5% short term in Singapore over the last two or three years has basically almost zero impact on DBS CASA. This brings us back to the equation I just showed everyone earlier: With the low cost of funds, DBS is able to generate net interest margins in excess of its peers. In turn, it allows it to have a higher ROE, which fits our wealth-creating criteria. I won't go into the details, but we expect DBS to generate a ROE of about 15 to 16% over the cycle. ROEs will shift up and down with interest rates, but this 15 to 16% in the context of Singapore, where government bonds yield at most about 4%, that's well in the wealth-creating territory for us at Mawer. If there's one key point you need to take away, it’s that DBS has the lowest cost franchises in Singapore, which enables it to generate wealth-creating returns. Then we lay on the management piece, where DBS is run by Piyush Gupta. He's been with the firm for at least over a decade, which is also one at the same time we've been invested in the company. He has been a good capital allocator, and I think one important piece is that the company is shifting towards a higher payout ratio. They're going to be paying out about 70% of their earnings over time. This is really important because if you go back to that equation I wrote to you, this comparative advantage that DBS has on funding only applies to Singapore. Unfortunately, Singapore has limited growth potential. If management is going to be allocating more and more capital outside of Singapore, where they do not have that strong franchise and they do not have that funding advantage, then over time, you will expect that return on equity to erode. But by committing to a higher payout ratio, it minimizes that risk of capital misallocation. We as investors will just get paid back our returns by dividends rather than have to stress out and worry about, “Hey, if they're going into a, if they're going to spend a lot of money in other countries, will this be wealth-creating or not?” To wrap this up, DBS has a strong deposit franchise. It's run by an excellent management team who are good with capital allocation. Lastly, in our models, we have it in a 9 to 11% IRR (internal rate of return) range, trades at 1.8 times price book. In the context of a normalized 15 to 16% ROE, we think it's very attractively or still attractively priced in where it is now.

[00:11:54] Andrew Johnson: Let's keep it moving over to North America where Grayson Witcher will take us through the U.S. banking sector and how industry leader J.P. Morgan navigates the competitive landscape.

[00:12:04] Grayson Witcher: There are around 4,000 banks in the U.S. Banking in the U.S. is one of the most competitive industries, along with restaurants and retail. Americans love to shop. Approximately 70% of U.S. GDP is consumption. What's even better than spending your own money? Spending someone else's money, which is where the banks come in. You can borrow money to buy a house, to buy items on your credit card or to buy a car, or all of those at the same time. The consumer doesn't really care who gives the money, because money is money. There's very little differentiation between banks apart from the interest rate they charge. As a result, banks often end up competing to offer consumers the lowest price or interest rate possible. Compare that to the shoe industry, which itself isn't the greatest industry by any means, but it may be more attractive than banking. People will happily pay $200 for a pair of Nike shoes, even though they could buy a pair of cheaper shoes or a pair of no-name shoes for $20. Why do they do this? It's because they value the brand. But nobody would take

out a mortgage at 15% when they could get one at 5% because they like the bank better. U.S. banks have a weak competitive advantage.

What about the risks? Banks are lending people money and hoping to get paid back. Of course, they've been doing this for hundreds of years. Even the U.S. banks, many have been doing it for a hundred years, so they're well-aware of the risks, which is why they only lend to certain people who they think are going to pay them back, so look at things like your income, your credit score, etc. Of course, they can get it wrong. You can lose your job, you can borrow too much money and not be able to pay them back, so this is why during times of stress like recessions, banks have to provision for loan losses. When you look back at 2009, for example, the last big recession, loan losses went from half a percent to over 4%. Of course, banks have leverage, which makes it even worse. Let's talk about valuation. Investors are well-aware that banks have a relatively weak business model. That's why they trade at a significantly lower PE or valuation than other investments. Banks typically trade—of course it varies—but they typically trade at 10 or 12 times price to earnings (PE), whereas non-financials will trade at double that—at least 20 to 25 times earnings.

Given that backdrop, why do we own any banks? We only own one true bank, and that's J.P. Morgan. We own them because they have a top-tier management team. In a competitive industry with low barriers to entry and relatively high risk, you need an excellent management team. With J.P. Morgan, you do have an excellent management team. How do we know that? We can look at it through different financial lenses. Returns are relatively high and attractive for J.P. Morgan. Their return on equity (ROE) is around 16.5% over the last 12 months. Their leverage is fairly low. If you look at their tier one capital, it's about 17%. Their underwriting, we believe, is better than average, significantly better than average. You look at their charge-offs, for example, during 2009, they're about 3.5% as a percent of loans. So this combination, good management team—and you can see that in some of the stats—has allowed them to grow deposits in good times and not only survive the bad times, but thrive, purchasing distressed banks for attractive prices in many of those difficult financial times. You look back at 2009, for example. J.P. Morgan was able to buy Bear Stearns and WaMu, Washington Mutual, as those two institutions collapsed. More recently, in 2023, they were able to buy First Republic, which is a smaller bank that basically collapsed or was near collapse when they were purchased. Management is critically important for banks, and that's why we own J.P. Morgan. J.P. Morgan is also unique in that it owns some pretty unique financial assets under its umbrella that many traditional banks don't. They have Chase Paymentech, which is a payments business that allows small, kind of any business, including small businesses, to accept credit card payments at their stores. You've likely seen these on the POS devices you tap your card on when you go in to pay using a credit card at a store. That's a pretty good business. They have an investment bank—one of the largest and strongest investment banks in the world—and they have an asset management business. In that business, they're not lending you money, but they're taking your money and investing it, which is a much lower risk business than classic banking business.

That's a little bit about banks in the U.S. and how we think about them. It's an extremely competitive industry, which is why we believe the competitive advantages are typically on the lower end of things, lower end of the range for U.S. companies. There's a quite a high amount of risk in the banking industry. You're giving people money and hoping they pay you back. There's a lot of leverage wrapped up in that. When times get tough, they can get into trouble pretty quickly. That's why you see things like run on a bank, so a relatively high-risk industry. Management: That's why management is very critical when looking into banks in the U.S. We spend a lot of time thinking about management teams. Of course, valuation is the other offset. Once you know how strong a competitive advantage is, what the risks are, how strong the management team is, you can look at the valuation and see if that compensates you for those different characteristics. Banks in the U.S. are a tough industry, but if

you look long and hard, you can find some real gems because there's a huge amount of diversity in the U.S. and some great companies within that competitive industry.

[00:17:28] Andrew Johnson: We're going to stay in the U.S. but this time with Alex Romaines, who will dive into the story of First Citizens Bank and how they capitalized on recent market turmoil to grow into a key player in the industry.

[00:17:39] Alex Romaines: The banking industry in the U.S. is a little bit different to other geographies such as Canada, where it's highly consolidated. It's still quite fragmented in the United States. That really comes from very old regulation, which prevented banks from operating in multiple locations. A hundred years ago, there were about 30,000 banks in the U.S. Then throughout the Great Depression, a lot of banks went under, there was the Glass Steagall act, the creation of the FDIC. Coming out of that, there were about half the number of banks, so about 15,000. That stayed pretty constant for quite a long time, really, until the saving and loan crisis of the ’80s and early ’90s. During that period, again, a lot of banks went under, and there were also a lot of mergers. That was when the industry really started to consolidate again on a trend that has largely continued through to today, where we have just under 5,000 banks in the U.S. The industry was relatively stable until the great financial crisis, when there were obviously a lot of problems. Some large banks went under; a lot of the big banks had to take bailouts in order to survive; and a lot of banks were caught holding mortgages that they shouldn't have made or having purchased mortgages from originators that they shouldn't have purchased. There was a lot of turmoil. However, since then the banking industry has been fairly robust. Banks have been well-capitalized. We hadn't seen too many problems. That was until March of 2023, which is colloquially referred to as March Madness, when some banks started to run into some issues. That was when the U.S. mid strategy started to look at some banks as potential investment opportunities.

Banking is inherently fragile because it's a leveraged business model. However, we do think in certain situations, a bank can fit our core investment philosophy. The first bank we took a look at during that time was a bank called First Republic. We ended up buying and selling First Republic in a relatively short period because we realized we'd made a mistake, but I'll walk you through what attracted us to it in the first place. First Republic really got into trouble because it committed a cardinal sin of banking, which was that it lent long and borrowed short. It was taking in deposits, which a lot of them had come in a very quick period over the prior couple of years to it getting into trouble. The duration of those deposits was relatively unknown, and it had made several fixed-term loans in its lending book, which it then found very difficult to adjust, obviously, when the interest rates rose sharply. It also made several investments in long-dated bonds, government bonds, which were underwater as interest rates rose. All of this sparked a run on the bank, and deposits were being withdrawn quite swiftly. The bank was suddenly facing a funding crisis, and it began to decline quite rapidly, the share price. The U.S. mid strategy had to look at this, and we realized that there were definitely problems at the bank and the risk that it would blow up was definitely real, however, the underlying banking franchise was quite strong. Other than the balance sheet errors, it had been relatively well-managed. We weighed the possibility of the run on the bank being fatal versus the apparent discount to intrinsic value that we would potentially get if the bank were to survive. We ended up changing our mind because one thing we didn't initially account for, was the fact that as the deposits were flying out of the bank, it was transitioning quite quickly from being funded by relatively cheap deposits, to then being funded by rather expensive wholesale funding. That drastically altered the earning power of the bank. It was something that we knew was going to impact the bank to some extent, but we didn't realize quite the extent to which it was going to happen. We ended up selling, which probably proved to be smart because the bank essentially was shuttered and in a forced sale to J.P. Morgan.

During the turmoil of March, there was another bank that caught our eye too, and that was First Citizens, which

remains in the U.S. mid portfolio today as one of our top holdings. This really is the bank that we should have focused our attention on initially. First Citizens made headlines because they acquired another bank that struggled during the March crisis, which was Silicon Valley Bank. Silicon Valley Bank had made some similar errors with respect to their balance sheet. In addition, there was some added fuel to the fire from some high-profile people in the Silicon Valley area, publicly stating that they did not trust the bank. This sparked a run on the bank. SVB ended up in trouble and ended up going through the FDIC auction process, where First Citizens was able to put in a successful bid and purchase the bank at a substantial discount. This wasn't actually the first time that the bank had done this. First Citizens had quietly been acquiring banks, either through FDIC auction or through general merger and acquisitions over a long period of time, and the bank had compounded its book value of equity, at an extremely high rate. If you look today versus 10 years ago, they've compounded their book value at over 20%. Every year they've been generating excellent returns on equity, a highly profitable bank. During the financial crisis, for example, they suffered like every bank suffered a little bit, but they didn't get caught up in much of the craziness of that time. The bank had recovered profits largely by 2010 and has steadily marched on since then. This is a bank with an excellent management team, but also a unique one in the sense that it's still largely or insignificantly controlled by one family, which is the Holding family, including the CEO, Frank Holding, Jr. I think in total, the Holding family owns about 20% of the bank. It's basically unheard of to have a bank that size being basically family-run. I think that's important because that skin in the game has helped the bank avoid doing lots of things that harmed other banks. We looked at First Citizens, and it appeared to be trading a discount to intrinsic value. It turned out to be quite a successful investment for us. The worries with Silicon Valley Bank were that First Citizens may not have the expertise to carry on some of the niche startup lending activities that Silicon Valley was involved in or wouldn't be able to support the digital banking side. So far, First Citizens has held in, they've managed the bank relatively well, and the discount that they purchased the bank appears to have held, and it does appear to have been a bargain in hindsight. Now the shares, I would say, are less drastically undervalued than they were when we looked at it, but we still expect to generate a good return from that investment. Going forward, we're still mindful that banking as an industry is quite fragile, but that sometimes that fear creates opportunities. As long as a bank fits our core philosophy of creating wealth run by an excellent management team and trading at a discount to intrinsic value, it'll be something that we'll consider.

[00:25:26] Andrew Johnson: Next up is Mark Rutherford to discuss the unique traits of Canadian banks, touching on their conservative strategies, as well as the role that consolidation has played here in Canada.

[00:25:36] Mark Rutherford: Great to be here, Andrew. Happy to talk about Canadian banks, what we observe in Canada, how there may be differences and nuances that may not be apparent at first glance, and some of the key factors that we watch in the Canadian banking sector. One thing that I'd highlight at the very start is just that Canadian banks are very similar to other global banks in the sense that they're raising some common equity, preferred shares, often borrowing some debt, gathering deposits from consumers and businesses, and then lending those out at a spread. It's a leveraged business model. You do see the assets that are on the balance sheet at a very big multiple relative to common equity in the business. That range has changed over time, but can be 18 to 20 times assets to common equity. What does that mean at the core of it? If you had in the very worst case, 5% of your assets go bad and are written off, then your common equity is totally written off and there goes your business. It is a leveraged business model by nature, and that's why the industry historically is very conservative. When they loan people money or businesses, those loans need to be paid back, and there can be losses, but banks work really hard to make sure that those losses are provisioned for and really minimal over time. Just from a mental model perspective, ultimately the banks, just like other banks outside of Canada, are selling a commodity. If you can get your mortgage, Andrew, at TD for 4.9% and Royal Bank at 5.1%, TD is probably going to

win your business and same thing if the opposite was the case. Banks have to compete on service, on the breadth of their offering, on availability, maybe in terms of whether branches or customer service is easy to access. It's very hard to differentiate yourself to a significant degree from a service perspective. There are nuances and the banks have strengths in different areas, but ultimately we have to enter looking at this sector with that mindset. Why does that matter? If one bank or an area of the business is growing faster, much faster than the others, we wonder. The first thing we're always asking is, why is that happening? Is that because they're being more aggressive? Are they taking advantage of some new areas because they have the capital to do so? Getting under the hood and trying to understand those changes.

If we look at Canada as a whole, one thing I'd really highlight compared to other banks around the world is just the level of consolidation. You could take the major bank CEOs and have a few of them at your kitchen table, and that would be 90% of the Canadian market. It's a very consolidated market with Royal, TD, Bank of Montreal, CIBC, National Bank, Scotiabank. Those are really the major Canadian banks. What we've seen historically is that those Canadian banks have generally played by fairly conservative or taken fairly conservative approaches and grown steadily over time, but had a reasonable profitability. Historically, if we look at the ROE range at Canadian banks relative to other global banks, we do see very attractive returns on equity. You're looking at 10 to 15% return on equity at the Canadian banks over time, which is very attractive. Part of the reason I think that drives that is just industry structure. If you have thousands of banks in the U.S. or other markets where there's just a much higher number of banks, the odds that one bank might stretch to make that loan are likely much higher because it only takes one to really get the loan. Whereas in Canada, if the top five banks don't give you the loan, the odds are you probably aren't getting the loan. There's much more reasonable competition from our perspective over time, and that drives healthy returns. Then they're also able to capture, all capture a reasonable degree of growth.

The one thing that I'd really highlight that's changed within the Canadian bank landscape over the last 30 years is they're much less dependent now on simple spread income on their loan books. They've built out much more robust wealth management, capital markets, insurance businesses over time that is more steady fee income relative to 20 or 30 years ago. If we look at net interest income—you can think of that as interest they're making on the loans—that's roughly half of their revenue stream today. The other half really comes from these other components of the business: wealth, capital markets, insurance. From that perspective, there are different drivers of each of those segments. I think it's really important within Canada to highlight how important the regulator is. We think about it internally here as a little bit of a grand bargain. The banks are allowed to earn healthy returns and generate profits and grow over time, but there's also an implicit agreement with the government and the regulator that, hey, if you're allowed to make a reasonable amount of money and attractive returns for your shareholders, you also need to be supportive of economic growth, treat your customers fairly, and you can't be out there cutting jobs very aggressively at the first sign of a downturn. Our observation is that relationship appears healthy and has been healthy over a number of years, where you're seeing sound regulations that move slowly, and they're predictable for the banks to react to, and they're working to balance the interests of many stakeholders, as the regulators charged with looking after the safety of the system, the safety of regulators. They also want to incentivize the banks to grow and invest and lend to consumers, as well as businesses that need access to capital.

Next, it's important to touch on just the individual banks and how they differ from one another, maybe starting with Royal Bank, a very dominant Canadian retail and wholesale franchise, increasing market share most recently with the HSBC acquisition. We think that's a really wise decision given every dollar deployed in Canada is generally higher return equity than other areas of the world. TD: their business model, very big again, dominant Canadian retail bank, as well as a very big U.S. retail presence. They also have interest in Schwab and that

growing wealth business as well. That business, more retail focus, a little bit less capital markets-focused than Royal Bank and also a very retail focus in Canada and the U.S. Bank of Montreal: I'd highlight that much more of a commercial bank, so less earnings coming from core retail banking like Royal and TD, but very strong in commercial banking, very strong capital markets and wealth businesses that have done very well over time. With that, they've grown at high rates. That's been attractive, but with some of the higher commercial loan growth, you do see higher and a little bit more volatile loan losses. That's one thing they contend with in their business model. Then Scotiabank: much more of a dominant Canadian retail and wholesale bank with a wealth business as well in Canada that's quite dominant. A big proportion of earnings, so roughly a third of earnings for Scotiabank, do come from international markets, Chile being a big one, as well as Mexico and other markets. You do see very high returns on equity in some of these international markets, but again, there can be higher loan losses, other challenges in dealing with international markets. It does give you some differentiation between each of the businesses. In the portfolio, because there's enough differentiation between each of them, we do emphasize and deemphasize them over time to try to position ourselves for the best risk-adjusted return for the portfolio.

When we look at all these factors, Andrew, to wrap it up, what we do see is very strong Canadian banks. They're conservative by nature. They earn very reasonable and attractive returns on equity. The regulatory nature in Canada is very important. We watch it very closely. Any changes to that are in our view, likely the number one risk to Canadian bank profitability. So far over time, we have seen a relatively healthy relationship and a sound regulator that's made prudent decisions, balancing the shareholder interests. The banks continue to grow and find new opportunities to make money. They've diversified themselves over time, adding wealth, insurance, capital markets, businesses. From our perspective, they remain very well-positioned, and when we stack them up even globally, they seem very attractive to this day, so very happy to continue to hold Canadian banks in the Canadian equity strategy.

[00:35:26] Andrew Johnson: Our second last stop is India, where Siying Li will talk about HDFC Bank and its position with a rapidly growing Indian economy.

[00:35:34] Siying Li: We're talking about HDFC Bank, which is the largest private sector bank in India. This is a core holding for both our international equity platform, as well as the emerging market platform. One may ask, why are we invested in a bank in India out of all the places in the world? Let's talk about it. Banks in India have a long history of being run by the public sector. The private banks were actually only first allowed to operate following the reforms in 1991. That's only a little bit over 30 years of history for the private sector banks. The public sector banks have a majority of the market share, but they are losing market share year after year. That is because they are not as well run as private sector banks, because they have a different objective than private banks for after profit, whereas the public sector banks are owned by the government.

There have been two pretty large banking crises in the history of India. One in 1992 to ’93, where the gross non-performing loans reached 23 to 25%. That's pretty huge, if you think about a quarter of your loans have reached non-performing status. The second banking issue started in 2009. The numbers only started to show up in the balance sheet and income statement of these banks in late 2010s. The reason for that was the government was pumping a lot of liquidity into the system. In 2019 and 2018, there were six public sector banks. They had bad loan rates of more than 20%; 14 of the public sector banks had more than 15% and only two public sector banks had bad loan rates in the single digits.

Let's put that picture aside. How did HDFC bank do during this crisis? Its non-performing loans was lower than 1.5% throughout the time of this banking crisis and in its history. HDFC bank has around 12% market share in banking for the whole India. That's around a quarter of the market share within the private sector bank segment,

and it does fairly plain vanilla deposit and lending business. Non-interest fees are really generated from a banking fees and low underwriting fees, no very fancy derivatives or types of financial products, which is what we like because when the banks get into very fancy products, it becomes more and more of a black box for investors, and it's hard for us to know the type of risks that they're taking on.

Why are we investing in HDFC Bank? As I alluded to, the industry picture that we talked about in the beginning, they have a group of very weak competitor, and that's the public sector banks. The public sector banks have 60% market share, but they're donating market share to the private sector every year. Over those 30 years, their market share essentially went from 100% to 60% today, and the expectation is that they will continue to be lower going forward for the public sector banks.

That's one part of the thesis. The other part is the macroeconomic environment for India. It's a very fast-growing economy. The banking penetration is just increasing year over year for both urban and rural areas. People are becoming more comfortable with banking, putting their money into this thing, entity called bank. The public's more comfortable and more comfortable with taking out loans, so we have the macroeconomic growth for India. There's the banking penetration increasing in India, and then there is growth from taking share from the public sector bank, so a number of growth pillars for HDFC Bank. HDFC Bank is also run by a very good management team that understand how to adjudicate risk as we talked about, very low non-performing loans over a long period of time over different economic cycles, and also having scale in many different parts of their operations. It has 50%, for example, market share of all salaried accounts of people who are actually earning a monthly salary, working with a large reputable corporation. Fifty percent of these people in India have an account with HDFC Bank. They have pretty high market share for high-margin products like credit cards. Also, their technology team is at the forefront of developing consumer-friendly, efficient technologies for the banking sector, well, for themselves, not really for the banking sector, for HDFC Bank. With all of this operation scale, the good technology scale and a good growth. this has resulted in 15 to 20% of ROE over the last decade. Good risk adjudication resulted in low non-performing loans rate and a bank that's growing 20 to 40% a year over the last decade. The last thing I would say is that more recently, this bank is into a slower growth period due to both of the macroeconomic condition and integration of the largest financial institution, integration of an acquisition of the largest it's ever done, which is HDFC Limited.

We're long-term investors. They definitely have, in the short term, the benefit of the doubt to integrate, to fully integrate, and effectively carry on with the growth and operation trajectory that they have carried out since they've started operating. We still believe that this is a good investment for us for the long term. Over the last year, the investment thesis has changed slightly because the bank has acquired one of the largest financial institutions in India, which is HDFC Limited. It is actually a sister corporation, and it is going through some slowdown in growth because of the amount of integration effort it needs to take on and also in the macro environment, there is a bit more competition within the private sector banks. We're still very much invested in the thesis and trust that the management will be able to overcome these short-term challenges and be able to continue to deliver the growth and operation excellence that it has been able to deliver in the past.

[00:42:08] Andrew Johnson: Finally, our last stop takes us to Japan, where my colleague Asim explores the history and evolution of banking in Japan, as well as a look at Mitsubishi UFJ, one of Japan's largest and most influential banks.

[00:42:22] Asim Hussain: Before I go into the competitive backdrop for Mitsubishi, let me just give you some history on the Japanese banking system. In the 1860s, we had the Meiji Restoration. Japan opened up to the world. They decided that they wanted to get on par with the European powers in America at the time and to avoid

getting colonized. They started industrializing very rapidly by taking in U.S. and European technology. One of those technologies, which is not traditionally seen as a technology, is the banking system. In 1880, they set up Yokohama Specie Bank. This bank later became Bank of Tokyo after the Second World War ended, where of course Japan lost, 1946. That same year, Mitsubishi was founded by an ex-samurai called Iwasaki. In 1919, Mitsubishi as a group became quite powerful in Japan. They were a conglomerate; they had the bank, they had Mitsubishi Corporation, the commodity trading arm, they had Mitsubishi Heavy, Mitsubishi Motors, Mitsubishi Chemical, Power, and even Nikon.

These were all companies that were part of what's called the Mitsubishi Group after the war. The U.S. dismantled this conglomerate to prevent its power from reemerging, so Mitsubishi Bank became managerially independent. Following that, there was another bank that was set up called Bank of Tokyo that was just responsible for foreign exchange trading as Japan traded with Europe and the U.S. Then fast-forward to the 1990s. We've had now four or five decades of rapid Japanese growth, but the early ’90s marked the end of that period, so there's an asset bubble in both property as well as stocks. That led to, of course, the ensuing bust, which brought the Japanese economy to its knees and the financial system to the brink of insolvency. The Japanese financial elite had to decide how to proceed in this very tough backdrop. They did what most other elites do in any other financial collapse, which is basically consolidate. In 1996, Mitsubishi and Bank of Tokyo, Bank of Tokyo being the FX trading arm, historically, of the Japanese state, and Mitsubishi Bank being that runoff, newly independent bank, they merged. Then that led to the establishment of the original Mitsubishi UFJ. Then in 2004, after 10 years of banking, morass and stagnation of the Japanese economy, Mitsubishi, then Mitsubishi Bank, and Tokyo combined with UFJ Holdings, another bank, to create what is now today Mitsubishi Tokyo Financial Group. This merger was completed in 2005, one year later. Finally, we had another minor merger where UFJ itself was made from Toyo Trust and Banking Corporation. We have a history of a bank that was created in the post-war era, but started in the major restoration period in the 1800s. Now we have this mega bank, which is the term the Japanese use for the top three banks: Mitsubishi UFJ, Mizuho, and SMFG, which is Sumitomo Mitsui Financial Group.

In terms of competitive landscape, I set out the three major banks. There are actually 110 banks in Japan. Japan is quite overbanked, but these three banks are the most global. They have the most scope and scale within the domestic and foreign economies. Mitsubishi itself has an 8% market share for loans. This compares to 7% for Mizuho and 7% for SMFG, so they're roughly on par with each other with Mitsubishi being first among equals. Mitsubishi is a more corporate-leaning bank, but not particularly, just compared to SMFG. They also, of course, have an implicit government backstop because they're a globally systemically important bank. This is important because their cost of capital will be lower than other banks who don't have that backstop. These other banks will typically be smaller banks. They have 3 trillion in assets. To give a sense of, in U.S. dollars, to give you a sense of Mitsubishi UFJ, think about them as the Bank of America of Japan, which is on the same level at 3.2 trillion in terms of total assets. This makes them the seventh largest bank globally. In terms of their competitive advantages, they operate across several different business segments, so they have a commercial banking and trust operations, they have consumer finance, credit cards, leasing operations, and they own a 23% stake of Morgan Stanley. They're quite diversified, which means that any business by itself is not enough to take Mitsubishi's earnings down and gives them a sort of stability that many banks in Japan lack, which are more domestically retail-oriented or too SME-focused, SME being small and medium enterprises, which makes them slightly riskier.

So why are we here? We have this massive Japanese bank. Japanese banks have been value destroyers for the best part of three decades. Why would we even consider buying this bank? Because things are finally appearing to change in Japan. What I mean by this is that ultimately banks—I'll go through the other various aspects of

Mitsubishi that make them attractive—but ultimately this is a rates play. In terms of interest rates, Japanese interest rates have been basically either negative or 0 since the bubble burst in the early ’90s. They've been negative since 2016 until about last year when they finally raised it into positive territory. Now they're actually even further in positive territory at 0.25. Now 0.25% for us Canadians is quite low. We hit 5% earlier this year, and rates have been coming down, but the rate remains significantly higher than they are in Japan. The reason this matters is that it's not just the interest rates, but where interest rates are going. Right now for Canada, the BOC has already started cutting. In the U.S. they haven't started cutting, but they might cut tomorrow. People are already expecting rates to come down in the U.S., in Canada, in the U.K., as well as in continental Europe, whereas Japan, things are going the opposite direction. This matters because as investors start pricing in the probability of future rate hikes, the bonds of the countries, the issuers, basically the government, which ends up being the benchmark for the entire bond index for the entire corporate and other issuers, that becomes what we call an upward-sloping yield curve. In other words, short-term rates are lower and long-term rates become higher as investors try to reduce their exposure to what's called duration. Duration just means the length, simplify the length of a bond's maturity so that if you have a very large, long maturity bond, that bond's price will move a lot more than if you have a shorter maturity bond. The Japanese yield curve, so overnight rate, two years, four years, five years, 10 years, 30 years, etc., that is upward-sloping.

In other words, Mitsubishi can lend long term for a much higher rate than they borrow short term from depositors and interbank funding markets. Whereas in most other regions, the curve is either flat or it's negative sloping. In Japan, it's the opposite. It's very much a tailwind. This means that for Mitsubishi, for every 0.15, not even 1%, but 0.15 or 15 basis points hike in the policy rate leads to a 150 billion yen net profit contribution for them three years later. The policy rate, if it reaches 0.5, then it's simply 0.15 times 0.53, 3.5, roughly 500 to 600 billion in net profit cumulative contribution. Given that they're targeting a net profit of 1.7 trillion by 2027, this is a significant contribution to that total amount, so about one-fourth to one-third. Their profits, just from the recent rate hikes, getting out of negative territory and then into positive territory already brought their profit into this year at 1.5 trillion, or 30% higher. We already had just from going from -0.1 to 0.25, at the moment, we've already gotten profits that are record high in the past 30 years-plus, and 30% higher than the previous year. This hopefully gives you a sense of how much higher profits can move if the Bank of Japan really is aggressive. That's the crux of the thesis.

In terms of a general conclusion for Mitsubishi UFJ, we are in Mitsubishi UFJ principally because of the upward-sloping yield curve that they have access to domestically, which is unique across developed markets and even some emerging markets. An upward-sloping yield curve is, of course, best for banks because they can lend long at higher rates than which they borrow short at lower rates. That creates a natural interest rate spread from which they benefit. Other aspects of the thesis which are important but are not crucial to Mitsubishi UFJ are their digitalization initiatives. They’re focused on reducing costs and their overhead by closing off bank branches and by reducing headcount. Domestically, they're pushed towards increasing their asset management business from one tenth of sales to significantly higher, growing at 9% into the medium term, which provides some recurring revenue and a more stable earnings, essentially. Finally, they have Morgan Stanley. This is one of the largest investment banks globally, one of the largest wealth operations globally as well. This has been providing a quarter to 40% of their earnings over the last decade, and we expect Morgan Stanley to continue to benefit them into the long term.

[00:51:46] Andrew Johnson: OK, we've taken a pretty comprehensive tour through global banking, whether it's been the stability in Scandinavia, in Canada, the growth potential that we see in India, the competition in the U.S., and the historical evolution in Japan and Singapore. What stands out across these regions is that successful

banks share a few critical attributes. Number one: strong management. Number two: strategic diversification across their business. And finally, the ability to adapt to market conditions. Understanding these factors can guide investors in making more informed decisions when navigating the banking sector. We hope that this has given you a view of both how different banking systems operate around the world and how they may fit within our portfolios. We'll see you next time.

[00:52:32] Andrew Johnson: Hey everyone, Andrew here again. To subscribe to the Art of Boring podcast, go to mawer.com. That's M A W E R dot com forward slash podcast, or wherever you download your podcasts. If you enjoyed this episode, leave a review on iTunes, which will help more people discover the “be boring, make money” philosophy. Thanks for listening.

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