DIAMOND HILL

INVESTED IN THE LONG RUN

Despite Elevated Uncertainty, We Have Liftoff

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Prussian field marshal Helmuth von Moltke the Elder is known for his military theory that "no plan of operations extends with certainty beyond the first encounter with the enemy's main strength." In 1987, boxer Mike Tyson simplified this concept down to "everyone has a plan, until they get punched in the mouth."

Bank stocks had a strong year in 2021, and 2022 was setting up to be a straightforward and positive year fundamentally for the banking industry. There was optimism about accelerating loan demand, the Federal Reserve was set to start raising rates and the economy was healthy. The investing environment should be easy in 2022, and the meme-stock crowd said all we had to do was take a YOLO (or is it HODL?) approach to our technology investments.

Then the market hit investors with a massive dose of uncertainty to start the year. The supposedly transitory inflation was looking less so by the month and, on this misread, the Fed pivoted to a more aggressive stance, causing a selloff in tech shares in the process. Then, Russia invaded Ukraine. The US and others moved quickly to tighten the economic noose around the neck of the Russian economy with the hopes of avoiding an escalating military conflict. Officials pulled hard on many levers simultaneously, and the full consequences have yet to be seen. What we know with certainty is that there will be consequences, some expected and hoped for, and many others that are unintended. Markets don't like high levels of uncertainty because, as famed Oaktree Chairman Howard Marks likes to say, "risk means that more things can happen than will happen." Unfortunately, the range of potential near-term economic outcomes has widened.

Despite increased uncertainty, on March 16 the Fed raised benchmark interest rates for the first time since 2018 and telegraphed additional increases through 2023 that would bring rates to their highest level since 2008. Increasing rates are generally viewed as a positive for the banking industry as it benefits net interest margins, which is the difference between the yield banks generate on earning assets (loans and securities) less their cost of liabilities (mostly deposits). During times of change, we are often asked how rate movements impact our estimates of intrinsic value for bank stocks. This is where the benefit of a long-term perspective comes into play.

When modeling the fundamental outlook for our bank investments, we look out over a five-year time horizon at what each bank's margin should be on a normalized basis through a rate cycle, and this normalized net interest margin is just one of multiple inputs used to estimate intrinsic value. In fact, I'd posit that the industry has done itself a disservice in drawing so much attention to movement in net interest margins versus its more important derivative, net interest income revenue, which makes up over 75% of total revenue for most regional and community banks. As First Republic Founder Jim Herbert says, "you can't eat margin."

While margin is important, the ability to grow earning assets can have an equal, if not larger, impact on a bank's bottom line. Looking at bank net interest income growth from 2015 to 2019, which captures the last Fed increasing rate cycle, we can see this in effect. For the roughly 130 largest banks (over $1 billion in market cap), the median compound growth in net interest income dollars during this period was 11%. Top quartile performers more than doubled the group median with compound annual growth of 23%. These top performers must have had the best net interest margin expansion, right? Wrong.

The top quartile had a median margin increase of 0.23%, and 10 of 32 banks in this cohort had margin *declines* during this period. Compare this to the third quartile, whose net interest income growth was only 9% but had a median margin increase of 0.26% and only seven banks with margin declines. The difference between these groups was the banks' ability to grow earning assets. Many of the top performers also operate in unique niches that allow for outsized growth, are based in geographies that have especially strong local economies or have expanded their franchise via acquisitions. All of these variables factor into our analysis of intrinsic value estimates, not simply the net interest margin assumption.

As we regularly reunderwrite our analyses and challenge assumptions, one issue we've been pondering lately is whether excess liquidity in the system has permanently lowered normalized margins for the industry. In response to the pandemic, a massive amount of stimulus was pumped into the system and found its way on to bank balance sheets via growing deposits. Many banks that normally operate at 85% to 90% loans/deposits are now in the 65% to 70% range since this influx of liquidity was met with muted loan demand, so excess deposits were deployed into securities with lower yields than loans.

No one, including most bank CFOs, knows whether this liquidity will eventually flow back out. If it doesn't, our normalized margin assumptions will likely prove too high, but our earning asset growth assumptions would also likely be too low. We experienced this over the last two years—margins were lower than we would've expected but earning asset growth was vastly higher, so net interest income revenue held up reasonably well given the margin pressure. This interplay highlights why simply concluding "rising rates = buy bank stocks" is, in our opinion, too simplistic and demonstrates the importance of understanding the drivers of banks' balance sheets.

These recent environments also highlight the importance of investing in resilient businesses with strong management teams capable of navigating fluid situations. The best management teams also often find ways to strengthen their competitive positions in times of heightened uncertainty. Therefore, we gravitate toward franchises that have demonstrated the ability to compound intrinsic value through various cycles with consistency, which usually comes from expertise in a lending niche, operational excellence and/or an attractive geographic footprint with demographic tailwinds. While the current environment is decidedly cloudy, it remains constructive for many in the industry.

As of 31 March 2022, Diamond Hill owned shares of First Republic Bank.

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