# Spotlight on the Financials Sector:
# Bank Profitability and Interests Rates

**Craig Callahan, DBA** - Founder & President of ICON Advisers, Inc.

*Contrary to more common opinions, we believe that Financials stocks' profitability can be independent of interest rates, even in low rate environments. The Sector is still undervalued and may be an attractive option in the current market environment.*

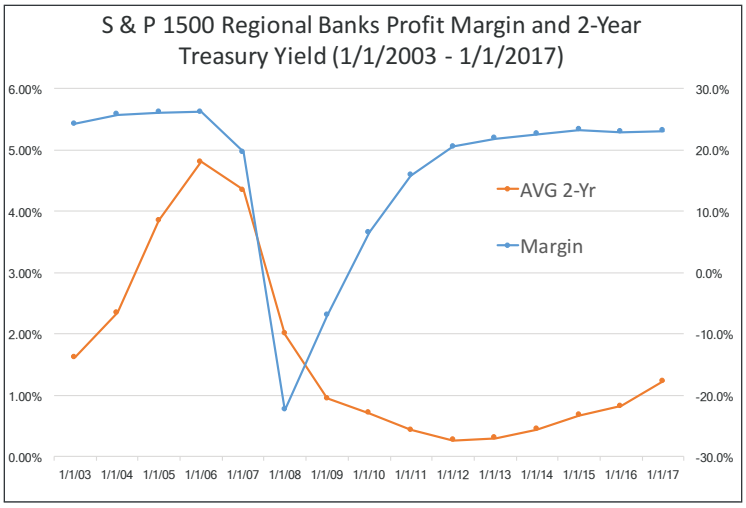
There are two popular views among institutional investors, such as hedge funds and mutual funds, regarding interest rates and profitability of commercial banks and other financial institutions. First, is the belief that commercial banks struggle to make money in a relatively low interest rate environment, believing that higher rates are better for commercial bank profitability. Second is the view that commercial banks struggle to make money in a flat yield curve environment and that a steep yield curve is better for the profitability of commercial banks. With a flat yield curve, long term interest rates are at levels similar to short term interest rates, whereas with a steep yield curve, longer term rates are higher than short term rates. Built into this second belief is the opinion that banks borrow (accept deposits) short term and lend (make loans) long term.

The popularity of these two views can even be seen in daily moves in stock prices. If the yield on the 10-Year U.S. Treasury Note decreases, bank stocks generally drop in price. However, if the yield on the 10-Year U.S. Treasury increases, bank stocks generally increase in price. It's almost as if institutions have those trades blindly programmed into a computer. Further, the movements in bank stock tends to be exaggerated if the yield spread between the 2-Year and the 10-Year U.S. Treasury narrows or widens.

In observing this, we couldn't help but wonder, "what if these institutional investors who are influencing the markets are wrong?" Well, based upon our research, we do believe they're wrong. First, we believe that interest rates, while a factor, do not single handedly dictate banks' ability to make money. We believe that bankers are very good at taking in money at one rate, marking it up about three percentage points and lending it out. They were born with that instinct and can probably do it in their sleep, so to speak. For example, if a bank pays 3.0% interest on deposits, that same bank might make loans at 6.0%. Similarly, if that same bank only pays 0.5% interest on deposits, it may make loans at 3.5%. Second, regarding the shape of the yield curve, we do not believe banks always borrow short term and lend long term. In our experience, bankers tend to try to match assets with liabilities. Money taken in on six month deposits are used for six month commercial loans. Money taken in on five year CD's is used for five year auto loans. We also think banks generally do not hold loans greater than ten years. If they do make a home loan, they usually sell it into a pool, such as GNMA, and simply book the origination fee.

## Profit Margin and Interest Rates

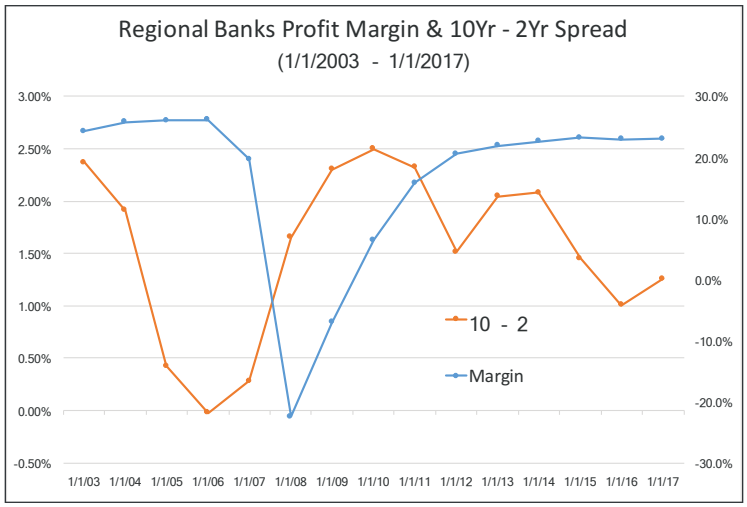
From Bloomberg, we obtained the annual profit margin for the stocks in the S&P 1500 Regional Bank Index back to 2003. We believe that the profit margin for this industry is primarily determined by banks' abilities to markup loans above the rates paid on deposits. The first graph below shows the profit margin for the S&P 1500 Regional Bank Index along with the yearly average yield on the 2-Year U.S. Treasury Note for each year.




**Data quoted represents past performance, which is no guarantee of future results. Source: Bloomberg**

Profitability in 2008 and 2009 was influenced by mortgage backed securities and losses on real estate loans. We will focus on 2003 – 2006 and 2012 through the partial year of 2017, when interest rates would have had a bigger influence on profitability – a time period that could be considered a more "normal" business environment. From 2003 to 2006, the average annual yield on the 2-Year Treasury, scaled on the left, increased from 1.62% to 4.81%. According to the popular institutional belief such a dramatic rise should have increased the banks' profit margin, scaled on the right, but the profit margin remained relatively flat. From 2012 through 2017, the yield on the 2-Year Treasury rose from .27% to 1.23%, yet profit margins were fairly flat, increasing slightly. While margins were lower in 2012 – 2017 than in 2003 – 2006 when the yield on the 2-Year Treasury was higher, we would argue banks would claim this was due to increased regulations and capital requirements that came about after the mortgage crisis, not low interest rate headwinds.

The next graph shows the annual profit margin for the stocks in the S&P 1500 Regional Bank Index alongside the spread between the yearly average yields on the 10-Year Treasury and the 2-Year Treasury, which we are using as a proxy for the slope of the yield curve. From 2003 through 2006 the yield curve flattened as the spread went from 2.37% to about zero, yet profit margins remained fairly constant. The spread again began a narrowing trend to a flatter yield curve in 2010, but that trend did not appear to hurt profit margins in the more recent years.

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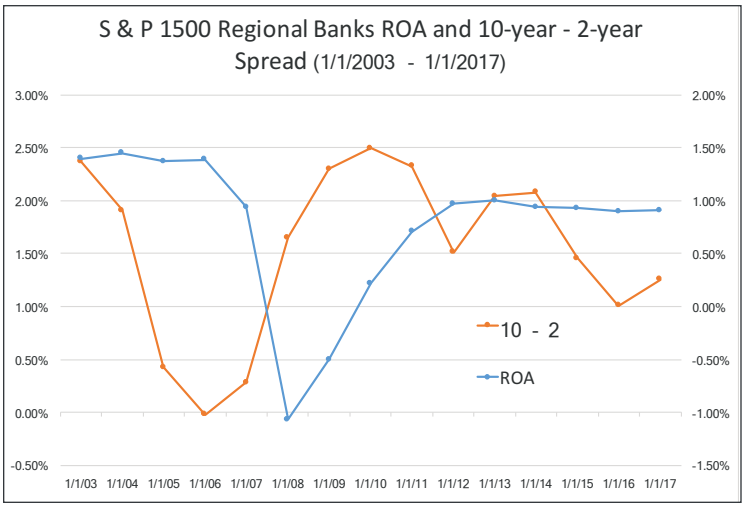
Finally, the last graph shows the relationship between ROA alongside the spread between the yearly average yields on the 10-Year Treasury and the 2-Year Treasury, which, as mentioned above, we are using as a proxy for the slope of the yield curve. From 2003 to 2006 ROA defied the popular belief that a flattening yield curve would hurt bank profitability. In more recent years the narrowing of the 10-Year minus 2-Year spread had minimal effect on ROA as ROA remained in the .94% - .91% range.

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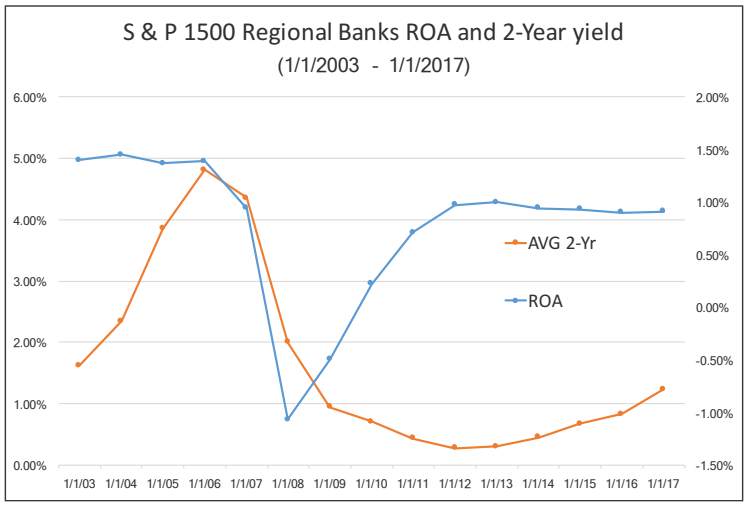
## Return on Assets (ROA) and Interest Rates

ROA reflects the income a bank can derive from all of its assets – primarily loans and bonds. The next graph shows the relationship between ROA and the yearly average yield on the 2-Year Treasury. The dramatic increase in the yield on the 2-Year Treasury from 2003 – 2006 failed to provide an increase in the ROA. Neither did the slight increase in yield from 2012 through 2017, suggesting the banks' ability to derive income from assets is independent from the level of interest rates.

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## Summary

The research we did on the profitability measures discussed above seem to counter the two popular beliefs that banks' profitability is a function of interest rates, the higher being better and that banks' profitability is a function of the slope of the yield curve, the steeper the better. Over the last two years, the Financials sector has been at the top of our value-to-price (V/P) sector rankings. We believe the sector has been given to us "on sale" because many investors are avoiding the sector based on two incorrect beliefs. However, since the severe dip in the market that hit a bottom on February 11, 2016, the S&P Financials Index has been the best performing sector index. Perhaps gradually investors are beginning to recognize value and to realize that widely-held beliefs are not always correct.

## In Conlusion

Based on further research, we believe:

- Bank profitability is independent of interest rates.
- Financials companies and specifically banks can be profitable even in low interest rate environments.
- The Financials sector has been and is still currently undervalued, making this an attractive sector in the domestic equity market.

*Please see Important Information on the following page*

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**DR. CRAIG CALLAHAN** *is the Founder and President of ICON, serves as a senior member of the ICON Investment Committee, and is chairman of the ICON Funds Board of Trustees.*

*Dr. Callahan created a valuation-model modification that advances the investment methodology originally developed by Benjamin Graham. Dr. Callahan received a bachelor's degree in psychology from The Ohio State University and a doctoral degree in business administration with emphasis in finance and statistics from Kent State University. He holds FINRA Series 7, 24, 63, and 66 registrations.*

***The data quoted represents past performance, which is no guarantee of future results.***

*Opinions and forecasts regarding sectors, industries, companies, countries and/or themes, and portfolio composition and holdings, are all subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security, industry, or sector.*

*Investing in securities involves inherent risks, including the risk that you can lose the value of your investment. An investment concentrated in sectors and industries may involve greater risk and volatility than a more diversified investment.*

*ICON's value-based investing model is an analytical, quantitative approach to investing that employs various factors, including projected earnings growth estimates and bond yields, in an effort to determine whether securities are over- or underpriced relative to ICON's estimates of their intrinsic value. ICON's value approach involves forward-looking statements and assumptions based on judgments and projections that are neither predictive nor guarantees of future results. Value readings are contingent on several variables including, without limitation, earnings, growth estimates, interest rates and overall market conditions. Although valuation readings serve as guidelines for our investment decisions, we retain the discretion to buy and sell securities that fall beyond these guidelines as needed. Value investing involves risks and uncertainties and does not guarantee better performance or lower costs than other investment methodologies.*

*ICON's value-to-price ratio is a ratio of the intrinsic value, as calculated using ICON's proprietary valuation methodology, of a broad range of domestic and international securities within ICON's system as compared to the current market price of those securities. According to our methodology, a V/P reading of 1.00 indicates stocks are priced at intrinsic value. We believe stocks with a V/P reading below 1.00 are overvalued while stocks with a V/P reading above 1.00 are undervalued. For example, we interpret a V/P reading of 1.15 to mean that for every $1.00 of market value, there is $1.15 of intrinsic value which has not yet been realized in the market price.*

*The unmanaged Standard & Poor's Composite 1500 (S&P 1500) Index is a broad-based capitalization-weighted index comprising 1,500 stocks of Large-cap, Mid-cap, and Small-cap U.S. companies. The Standard and Poor's (S&P) 1500 Financials Index is an unmanaged capitalization-weighted index comprising companies in the Financials sector as determined by S&P. Total return for the unmanaged indexes include the reinvestment of dividends and capital gain distributions but do not reflect deductions for commissions, management fees, and expenses. Individuals cannot invest directly in an index.*

*The 10-year yield is the benchmark 10-year yield to maturity reflected by the current issue 10-Year U.S. Treasury Note. The 2-year yield is the benchmark 2-year yield to maturity reflected by the current issue 2-Year U.S. Treasury Note.*

*Source: Bloomberg, FactSet*

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