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# NEWTON'S PAUL STEPHANY: UK BANKS 'JUST GEARED PROPERTY PLAY'

**By Paul Stephany, portfolio manager, Newton UK Opportunities**

UK banks are a geared play on the country's property market, according to Paul Stephany, UK equities fund manager at Newton, which is why he holds no exposure to them despite a 20% weighting to financials in his UK Opportunities strategy.

"Banks have volatile profits and in a low interest rate, highly-regulated environment there are such fears of another bail out that any time profitability looks like it is improving the government, through the Prudential Regulation Authority, forces them to raise capital," says Stephany.

The whole environment is the epitome of Newton's 'State intervention' theme he adds: "The government essentially wants the likes of Lloyds and RBS to provide simple, vanilla banking services – loans, savings and mortgages. Their management teams continue to want to do other, more risky things, too. The government only insures depositors in the UK up to £75,000, which is not the greatest vote of confidence in the sector and is perhaps telling us something about the direction of regulation."

When there is such a significant risk of negative state intervention in the running of a sector or business model, Newton prefers to steer clear, he explains. Although costly in 2004-7 in the great boom, this prudence paid off from 2007 when Newton's non-consensual decision not to invest in the UK banks worked in its favour.

## A leveraged bet

A key factor behind Stephany's decision not to hold any UK banks today is the amount of leverage they still tend to have: "Any increase in mortgage failures when taken across a leveraged balance sheet will impact profits significantly. In many cases banks are leveraged up to 30 times so if you take £1 off revenues it amounts to £30 off profit."

Additionally, since mortgages are still running at pretty high loan-to-value ratios, small changes in property values have a big impact. For example, if a bank has lent an 80% mortgage for a £200,000 house and the price falls by 10% the margin of safety has immediately been halved. Taking into account the fact house prices have risen by at least 10% in the past 12 months, to retrace by at least this recent run-up does not seem that unlikely in his view.

"The whole point of modern banking and the key product is mortgages – to lend people money at high rates and at low risk. The level of risk is deemed to be low when house prices are continually going up because people continue to feel confident and continue to pay their mortgages.

"But relatively small changes in property valuations can completely change the mentality of a bank: instead of wanting to grow its property book it will go into reverse. That is why in the past few months we have seen mortgage approvals fall and this is seen as a leading indicator for house prices," he explains.

Stephany thinks the idea of 'supply and demand' can be misleading when it comes to the housing market because there has always been and will always be high demand for good property in desirable locations. For this reason it is the supply of credit that is the chief factor at play – the willingness of banks to lend to people.

He adds: "What makes me concerned now is seeing affordability ratios – income to house price ratios – show similar levels to those seen in 1980 and 2007 and this looks unsustainable. Owning a bank in a time of falling house prices seems the wrong thing to be doing, especially given the fact people expect these companies to continue to grow profitability and dividends. This is why I hold none."

## The plus side

Yet as at 31 December Stephany held around 20% of his UK Opportunities mandate in financials. Standard Life is one of the firms in the sector he likes: "This business is a beneficiary of people's need to save money. It has the biggest investment platform for advisers holding client assets and now the government has introduced auto-enrolment a company like Standard Life will be there to help businesses big and small with the administration of what is a complex operation. Additionally Standard Life has its own fund management business which will be well placed to benefit from some of these inflows."

Prudential and Intermediate Capital are two of his other holdings in the sector and provide the fund with diversified global exposure – a theme across many of Stephany's positions, which he uses to bolster the strategy's resilience.

In the case of Prudential he says its products in Asia in particular are providing a lot of growth and this part of the business is now turning from being a net consumer of cash to a net producer of cash for the group. Private protection products such as health and life insurance are projected to have many years of growth ahead in Asia even if the region's growth is slowing, he adds, because people are unlikely to stop paying into these policies.

## Dig deeper

He cautions investors against taking the recent strong performance of some UK bank shares at face value: "Investors in Lloyds have seen its share price perform well but margins have widened. This is the spread between what it is making on loans and what it is paying out on deposits." This is a key indicator when investing in any bank and forms part of the forensic analysis Stephany has done on the sector.

"Lloyds in the UK has the worst quality mortgage book, partly due to its state enforced takeover of HBOS. In what other industry could you see the government force one troubled company to take over another troubled company? What that demonstrates is just how important the banks are to the UK economy and due to this critical role it is our view the regulators' prime aim will continue to be to ensure there is no financial crisis part two," Stephany adds.

Ironically it is the government's willingness to step-in that has put him off altogether: "It is an unnatural situation and there seem to be better ways to make money.  I would prefer to play the pockets of strength in the UK consumer sector and invest in undervalued global, resilient and cash generative large caps," he concludes.

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