

Banks vs. Resources

Should there be a new portfolio order?

By John Robertson

Reading time: 5-10 mins

Some long held views about the mix between banks and resources companies in Australian equity portfolios warrant reappraisal against the background of changing market conditions and a longer spread of data covering a full cycle for each sector.

The aim of this article is to highlight some changes in the investment characteristics of the banking and resources sectors.

These comments are prompted by the widely held view over the past 10 years or more that banks were a safe haven within the Australian equity market and resources were at the risky end of available investment options.

After more than 25 years, the prices of the stocks in the S&P/ASX 200 resources have finally caught up with the S&P/ASX 200 industrial stocks. The **chart on the right** shows the two series in the yellow and blue lines, respectively, since 1979.

Behind the convergence between these two series has been an even more dramatic shift in the pricing of banking stocks which has driven a large part of the movement in industrial stock prices. The track of bank prices in the S&P/ASX 200 is shown in the same chart in the red line. After appreciating at an average annual rate of 14.5% between the beginning of 1995 and the end of 2007, bank prices fell by 29.5% between the start of 2008 and 30 June (and by 29.3% from the start of 2008 until 15 September 2008).

What is normal?

These pricing patterns raise questions about what information should be retained and what should be discarded in drawing inferences about future performance.

▼ Is this convergence the result of a one-off resources up-cycle and a banking down-cycle coinciding, making these changes possibly unique and irrelevant to future decisions?

▼ Are the recent price moves a reversion to long-term tendencies in which neither sector can permanently outperform the other?

▼ Do recent changes foreshadow resources being a more competitive investment group than it has been for the past two decades?

▼ Should the apparent infatuation with the banks as an investment destination in the 1990s and early 2000s give way to them being treated as just as cyclical as resource sector investments?

These questions will not be answered definitively here. We can observe the history and, within some limits, describe confidently what has happened, but the future is far less certain and is open to more conjecture.

We can, however, go some way to identifying the possible risks associated with each sector with a view to taking them into account more fully than we might have done in the past as we frame our future investment decisions.

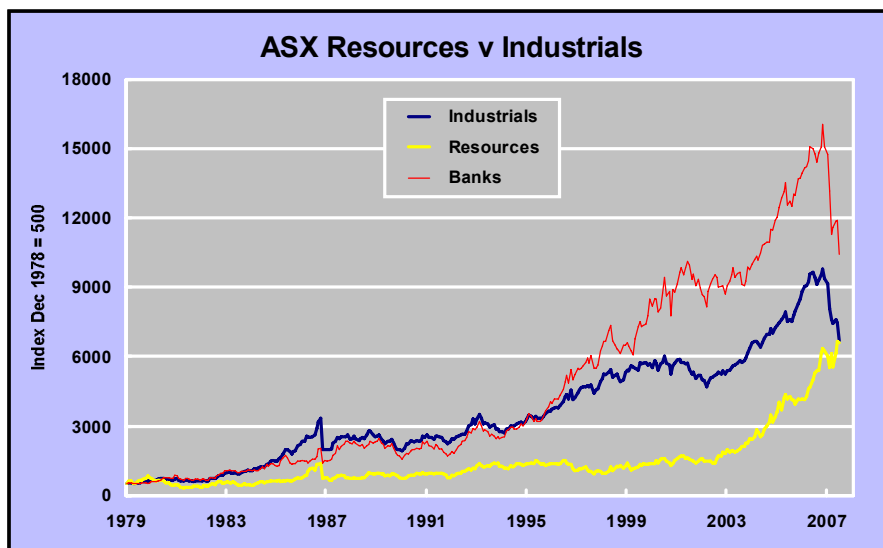
Banks: the sting in the tail

Apparently, stellar investment returns from the Australian banking sector have come with a sting in their tail.

The earnings growth necessary to fulfil the market's expectations about future returns required banks to wander from the largely secure deposit bases and local branding which had made them such attractive investments in the first instance. In Australia, as elsewhere, they not only began to borrow to lend more but also invested, sometimes unknowingly, in increasingly complex derivative instruments to help boost returns.

For them to deliver their advertised returns, many of these new fangled financial instruments required continuation of an unusual set of macroeconomic circumstances, namely, historically low interest rates and maintenance of an already prolonged period of relatively stable global growth. At a more micro level, this could be translated to mean household income growth continuing to outstrip mortgage repayments.

The evidence is now in that these conditions could not be sustained, leaving banks from Wall Street to the Great Wall risking failure. Of today's major Australian banks, National Australia, ANZ and Westpac have all had near death or extraordinarily uncomfortable experiences over the course of the last two or three economic cycles.



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The Commonwealth Bank has been relatively unscathed, but it had the lingering protections of being government owned until relatively recently. Then, there are all those other banks and building societies which no longer exist as separate entities because they had to be absorbed by one or another of the majors to avoid formal failure.

Despite assertions from some commentators that current US conditions are unique, losing major investment banks is not unusual. Drexel Burnham Lambert and Salomon Inc. both went the way of Lehman Brothers and Merrill Lynch after having reached similar industry prominence in their day. Between 1985 and 1994, 2,546 US commercial banks with assets totalling US\$789 billion failed in the savings and loan crisis, according to the Federal Deposit Insurance Corporation. In Japan, in the late 1980s, the banks were at the heart of the so-called 'bubble economy', which had many of the characteristics of the recent US experience, and then imposed a drag on a return to growth as they tried to rebuild their deflated balance sheets.

Precise circumstances might vary, but there is ample evidence of banks gravitating toward excessive risk no matter how ardently their CEOs claim to have de-risked their institutions.

Recent experiences of both ANZ and National Australia Bank, while less dramatic, show how easily this can happen.

In short, banks everywhere are just as prone to push to the edge of economic cycles as any of the most cyclical industries.

This prompts us to ask why conservative Australian investors are attracted to invest in such a demonstrably cyclical part of the economy in the first instance. Two reasons come quickly to mind:

1. a dividend income which other market segments have been unable to duplicate; and

2. a history of banks being able to claw back their profitability more effectively than other businesses after it has fallen.

There is community acceptance that, as official interest rates rise, banks should be able to raise their lending rates by the same amount. In using the slipstream afforded by official interest rate policy to price their services, banks have a ready made margin protection mechanism in a slowing economy that no other market segment has been able to cultivate.

In shepherding bank profitability, the central bank also offers emergency assistance if conditions become unexpectedly weak and foster business growth through reduced interest rates on the upswing. A liquidity infusion to reflate a flagging economy encourages banks to seek out new ways to deploy the funds to which they are given access by the monetary authorities.

This would make them superb investments but for their propensity to forget that risk is cyclical and that pushing for higher profitability near the top of a cycle invites disaster.

Despite the tendency to embrace more risk near the top of a cycle, the banks still seemed better investments than

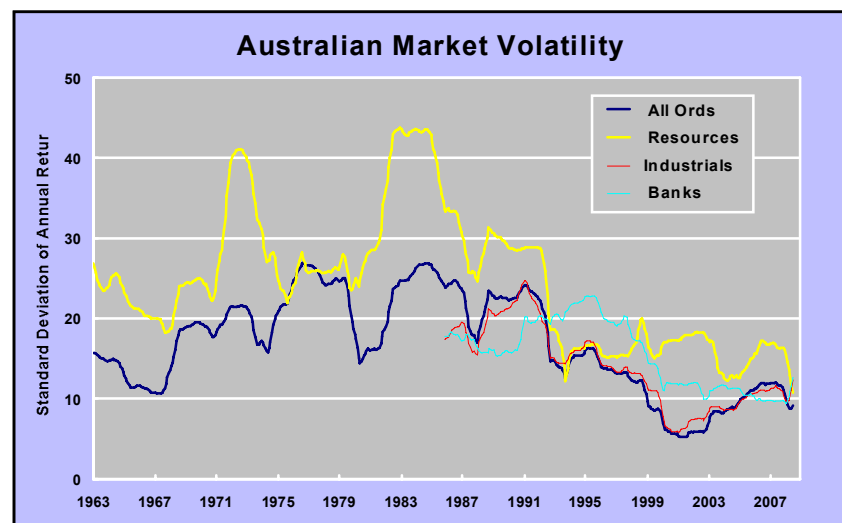
the alternatives from the resources sector, the other large, relatively cohesive segment of the Australian stock market. After all, the banks had outstripped resource sector annualised returns by some 6 percentage points over the 15 years to 1995¹.

Resource sector volatility

Resource sector investments brought their own set of peculiar investment risks² which were reflected in the volatility of resource stock prices. The **next chart** shows standard deviations in annual returns over rolling 60 month periods for the resources sector and, for comparison, the All Ords index for the past 45 years. The corresponding series for banks and industrials are shown since 1985.

Through much of the period surveyed in the chart, the volatility in resources sector returns was a quantum higher than in the remainder of the market.

Returns volatility dropped significantly across the board in the early 1990s in the aftermath of economic recession and ensuing macro and microeconomic policy changes which offered a more comfortable business environment. And over the past five years, the volatility in industrial and resources sector returns has converged.



¹ In price terms without regard to dividend payments.

² See the paper entitled 'Sitting on Top of a Mountain', presented by John Robertson at the August 2008 Portfolio Construction Conference <http://www.portfolioconstruction.com.au>.



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Changes in volatility have important implications for market values. As long as the volatility in resources sector returns is greater than that in industrial sector returns, everything else being the same, investors should pay more for an industrial earnings stream than for a resources sector earnings stream.

At a minimum, the convergence in volatility suggests that this conclusion is less clear-cut than it used to be and that a default to an overweight position in industrial stocks should be reconsidered.

Falling return correlations

The correlation between bank returns and resources returns has been falling. The **third chart** shows rolling 36 month return correlations between the banks and resources market segments since the early 1980s. The generally falling correlations³ imply the possibility of more diversification benefits from increasing the resources allocation in a portfolio vis-à-vis banking stocks.

The impact of these changed conditions can be modelled within a two asset portfolio using the Markowitz portfolio approach to find an asset allocation which maximises the portfolio return subject to portfolio risk.

Over the entire period since 1980, the banking sector annualised return of 11.3% was superior to the resources return of 9.5%. The standard deviation of bank sector returns was also lower than the standard deviation of resource sector returns. The model says that the optimal banks/resources portfolio split which would have maximised the risk adjusted return was 99/1 or, in other words, virtually no resources and a portfolio made up entirely of banks.

Applying the portfolio model to the post-December 1994 data set suggests a much less (54/46) bias toward banks.

Using prices only from 2000 and later, the model split would have been pushed entirely in the opposite direction (i.e. 0/100) so that there would be no banks in the portfolio.

What will happen?

None of that necessarily says what future allocations should be. A decision on that point will depend on, among other things, how representative of the future, if at all, these periods of time are going to be. No doubt, the period from 2003 to 2007 is unrepresentative of resources industry returns insofar as they were driven by a cyclical upturn in commodity prices of a type which happens, on average, only once every seven or eight years. But the decade prior to 2003 was also not representative and regarded by many as amongst the toughest conditions in the history of the resources industry. Equally, the period from 1995 to 2007 could not be taken as representative of banking returns since it fails to take account of their own cyclical tendencies. Banking conditions in 2008 are not typical either, but need to be combined with those that went before to provide a complete picture. Overall, 1995 to 2008 might not be such a bad selection of years upon which to base judgments about prospective returns.

Both parts of the market display peculiar and often egregious risks, but comparing the best of one and the worst of the other (which is what had been happening for much of the past 20 years) was never an analytically satisfactory way of resolving the choice between the two.

A reason to change?

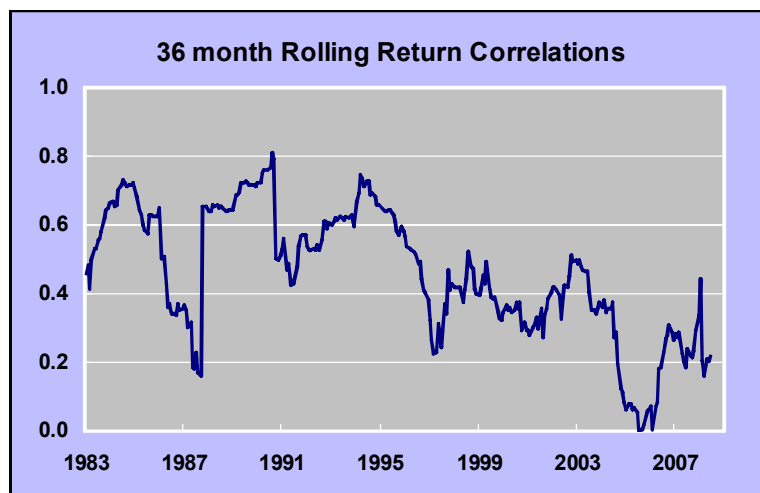
The fall in correlation between bank sector and resource sector investment returns has happened just as resource sector market volatility has diminished and the disparity in investment returns reduced. These three features in combination represent a considerable change to the investment landscape.

Now that the current generation of investment advisers has had a chance to experience a full cross section of market conditions, they might be in a better position to reconsider judgments about relative portfolio allocations.

Many had felt a compelling case had been made for a permanently high allocation to bank stocks. That should now be seen as a response to a peculiar, and ultimately unsustainable, set of circumstances. Equally, what some had once seen as a permanent underweighting of resources should also be seen as a reaction to a peculiar and unsustainable set of conditions.

Whatever our eventual conclusion about how funds should be allocated across the two sectors, at a minimum, we should question how this new information should be assimilated into our investment decision making processes.

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³ The latest spike shown in the chart was associated with the sharp fall in markets in mid-January 2008 when markets around the world irrespective of sector were pushed lower and recovered together