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SNL NASHVILLE NOTES

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Praise for coupon clipping and short-duration equity

By Jeff K. Davis

The second week of quarterly earnings releases from U.S. banks brought the same as the prior week — declining net interest margins due to intense competitive pressure on loan yields, sluggish loan demand, indications the top in mortgage banking has been set and vows of tighter expense management. It is not a compelling environment for bank investors even though credit and capital are in good shape. Another moniker is "dead money" for now.

Similar themes were apparent among other financials. Client activity was better for the discount brokers in the first quarter as compared to the prior, but daily average revenue trades, or DARTs, for Charles Schwab Corp., TD Ameritrade Holding Corp. and E*TRADE Financial Corp. were slightly below the year-ago quarter, which in turn were down from the prior year. Account balances were higher as the discount brokers benefit from their hybrid broker-deposit models, but the NIM on investible client cash balance was lower. Among the investment banks and universal banks, trading and banking results were OK, but not spectacular.

Growth, especially accelerating growth, is the mother's milk of equity investing; so too is buying discounted securities that have a potential catalyst to drive mean reversion of the valuation. I think equity investors in banks and most financials are going to have to focus increasingly on dividends to generate the return. Sustained earnings growth beyond a low-single-digit rate for most banks is not doable in the current environment.

Many institutional investors will not be happy with that, which may cause some rotation in ownership as fewer hedge funds may be inclined to work the sector. That does not mean bank stocks will become "under-owned," per se. Someone always owns the shares, though the demand and supply flows vary with market and industry conditions. My take on Wall Street is that dividends are an underappreciated means to drive returns — perhaps akin to cheating. Others ascribe dividends to giving up under the assumption capital can be deployed somewhere. But the beauty of dividends is that (a) cash is cash — the return is locked-in; and (b) risk and volatility usually are lower because the duration of dividend-paying stocks is shorter than nondividend-paying stocks.

Certainly dividend-paying stocks have achieved a lot of attention the past year or two as the Fed's zero interest rate policies (ZIRP) have dragged on. *Barron's* this week had an article about business development companies (BDCs) entitled, "A Smart Alternative to Junk Bonds." Last week's missive opined that ZIRP may pigeonhole most bank stocks as income plays and that some bank investors will migrate to BDCs and perhaps commercial-focused mortgage REITs.

The data supporting dividend-paying stocks is compelling except following periods of market weakness when earnings and/or valuations are compressed when earnings recovery and multiple expansion may occur. The accompanying table validates the point, but it takes several years for the compounding effect to work and it helps to avoid down cycles in credit.

Price returns vs. dividends in the total return equation for selected indices

		SNL Small Cap U.S. Bank (%)	SNL Mid Cap U.S. Bank (%)	SNL Large Cap U.S. Bank (%)	SNL U.S. RICs (%)	SNL U.S. Finance REIT (%)	S&P 500 (%)
10-year	Total return	14.6	-27.7	2.9	70.7	25.1	119.3
	Price return	-9.7	-44.1	-22.1	-35.7	-62.6	79.0
	Dividend return	24.3	16.4	25.0	106.4	87.7	40.4
5-year	Total return	-13.6	-35.6	-18.2	-3.2	44.2	29.0
	Price return	-23.5	-42.8	-25.8	-41.8	-26.3	15.4
	Dividend return	9.8	7.3	7.6	38.5	70.5	13.6
3-year	Total return	11.7	2.2	5.3	41.5	62.6	40.8
	Price return	4.6	-4.0	0.8	11.5	9.2	32.1
	Dividend return	7.1	6.1	4.5	29.9	53.4	8.8
1-year	Total return	14.3	11.7	20.4	23.9	27.9	17.6
	Price return	11.7	8.9	18.1	14.1	12.2	15.0
	Dividend return	2.5	2.7	2.2	9.9	15.7	2.6

Pricing data as of April 16, 2013.
Dividend return: total return less price return
Source: SNL Financial

For the SNL Small-, Mid- and Large-Cap U.S. Bank indices, the dividend return was the dominant return component in the total return equation for the three-, five- and 10-year holding periods. While the five- and 10-year holding periods included the worst banking crisis since the 1930s, the three-year return period was after the financial panic and recession ended. Even then, dividends were the dominant return component.

The same dynamic is true for the SNL U.S. Registered Investment Company and SNL U.S. Finance REIT indices, though that is to be expected since both indices are comprised of pass-through entities where about 90% of taxable income is distributed per law. The S&P 500 on the other hand generated the majority of its return through price appreciation. Yet, even for the S&P 500, dividends were a significant component of the overall return.

The search for yield and the Fed's indirect support of credit quality via its ultraloose monetary policies should continue to favor BDCs, which have to distribute at least 90% of their taxable income. Given their focus on mezzanine and senior secured lending to levered middle-market companies, asset yields are high, unlike those of commercial banks. And a number of BDCs have moved to tap the bond market for unsecured term debt and CLOs to diversify funding beyond bank lines. Further, capital rules for U.S. banks make levered lending less profitable. Mortgage REITs, on the other hand, offer yield, but they also offer the prospect of declining dividends in spite of creeping leverage given very low reinvestment rates for agency MBS.

My point is not that bank investors are going to have to chase yield, but the mathematics of valuation, earnings growth and the banking business model are going to force sector investors to look much harder at dividends in terms of calculating the prospective total return. It will also require patience and luck to time better entry prices. And it may be that with many more years of ZIRP, dividend payers will see multiple expansion vis-a-vis nondividend-paying stocks. In Louisiana that is known as lagniappe.

Obviously, a focus on dividend-paying stocks cannot replace credit. At year-end 2005, CapitalSource Inc. converted to a hybrid REIT to better compete with mortgage REITs in commercial estate, a sector that management had decided to make an ill-timed push. The conversion resulted in a change in the company's shareholder base to one that was more income-focused from that of a midcap growth stock. A couple of years later the REIT election was terminated as the company (successfully) worked through credit and funding issues, which resulted in another change in the ownership base to hedge fund and deep value players. But timing always matters. CapitalSource's three-year total return through April 16 was 65%.

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