Revisiting our Summer Thesis

From Dunce to Valedictorian

A basic tenant of our investment philosophy is that when stocks are inexpensive, unloved, or both, positive outcomes (excess returns) are more likely. We cite the recent performance of bank stocks as a third major example in the last five years (the others being defense stocks post-sequestration and health care stocks post-ACA passage). The key question currently facing dividend investors is whether the post-election rally in bank stocks is sustainable, or if most of the value has been realized. The investing narrative around our first two examples began with relatively low valuation and negative investor psychology and evolved to positive earnings estimate revisions and momentum. Our conclusion is that there is still value in bank stocks for dividend investors, but near-term we will look for more attractive entry points, as we evaluate the potential for earnings catalysts to move from speculation to reality.

As we noted in July, "U.S. banks remain an underappreciated and undervalued source of dividend yield and dividend growth… while bank stock valuations are near the low end of their historical ranges."[1] While our overweight position in banks was not predicated on politics, this positioning positively impacted performance over the last two months of the year. From November 8, 2016 to year-end, the KBW Bank Index rose 22 percent, as bank stocks rallied in anticipation of a lower corporate tax rate, higher interest rates, a steeper yield curve, faster economic growth, and a lighter regulatory touch (and corresponding higher capital return). Bernstein Research estimates the impact to earnings per share in a "blue sky scenario" could be as much as 30 percent on average, with the majority of the improvement coming from a lower corporate tax rate, suggesting earnings estimates may be too low.[2] As shown below, financial stocks held in our Equity Income Strategy participated accordingly, including M&T Bank, U.S. Bancorp, PNC Financial, and Bank of the Ozarks.

Total Return			
	2016	**Pre-Election (1/1/16-11/8/16)**	**Post-Election (11/9/16-12/31/16)**
Bank of the Ozarks	8%	-24%	42%
M&T Bank	31%	5%	26%
PNC Financial	25%	4%	21%
U.S. Bancorp	23%	7%	15%
S&P 500	12%	7%	5%
KBW Bank Index	26%	3%	22%

Source: FactSet

Outlook

On the regulatory front we anticipate slightly higher dividend payouts from our regional bank holdings and a modest uptick in merger and acquisition activity given higher valuations.[3] Some relatively straightforward regulatory reforms might include an increase in the threshold for being considered a strategically important financial institution (SIFI), from the current level of $50 billion in assets. In our view, such a policy would be well-served, placing the focus on the largest banks, which are significantly more operationally and geographically complex than their smaller peers.

Prior turning points in once out-of-favor sectors and industries suggest the current rally can continue, but we do not think bank stock outperformance is likely to proceed in a straight line, and we are not currently adding to positions. It is important to concede that investors are now anticipating many of the potential positive events which may or may not materialize. The details of upcoming legislative proposals will be heavily scrutinized, and turning proposals into law is likely to involve meaningful compromises, even when Congress and the White House are controlled by the same party. Higher interest rates and a steeper yield curve are likely to benefit net interest margins, but some of the benefit will likely be offset by more intense competition, and losses on investment securities and interest rate hedges.

Taking a slightly longer view, however, we find improving fundamentals and reasonable valuations, and remain positive on bank stocks. On a price-to-book basis, our holdings now trade broadly in-line with the 10-year average valuation (a period of depressed returns in a highly cyclical sector), but well below 20-year averages. Our expectation is that improving return will support higher valuation levels. On the whole, we see unexpected changes in valuation and psychology as evidence that semi-efficient markets create opportunities for patient investors.

CTC Equity Income Holdings: Recent Dividend Increases					
				Consecutive Years Dividend	
Date	Company	Increase	Dividend Yield	Paid	Increased
12/9	General Electric	4.3%	3.05%	117	1
11/22	Merck	2.2%	3.02%	40	7
11/21	Becton Dickinson	10.6%	1.70%	55	55
11/8	ADP	7.5%	2.32%	43	42
11/8	Six Flags	10.3%	4.48%	6	6
10/28	Honeywell	11.8%	2.42%	130	7
10/26	Texas Instruments	31.6%	2.79%	55	14
10/24	V.F. Corp	13.5%	3.08%	44*	44
10/18	Visa	17.9%	0.81%	9	9
10/13	Eaton Vance	5.7%	3.01%	36	36

Source: Bloomberg, company reports
Notes: International holdings are on a local currency basis
　　*At least 44 years.

[1] Dividend Quarterly, July 2016.

[2] McDonald, John. "U.S. Banks: Raising EPS estimates and looking at some additional Trumped-up scenarios," December 13, 2016.

[3] In September 2016, the Federal Reserve proposed reforms to its annual bank stress testing process (Comprehensive Capital Analysis & Review or "CCAR"), including removing the soft 30% cap on dividend payout ratios as early as 2018. On December 6, 2016, the Wall Street Journal highlighted the potential: Back, Aaron. "Banks Tease Higher Dividends." www.wsj.com/articles/banks-tease-bigger-dividends-1481058440

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