EQUITY STRATEGY REVIEW
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INTERNATIONAL EQUITY

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Among the myriad repercussions that the pandemic has had for equity markets, perhaps the most durable on a multi-year horizon will be the extent to which existing transformational or demographic trends – both familiar or nascent, value-creating or growth-eroding – have accelerated. Given our research efforts accentuate sustainable and structural trends at the industry level and operational excellence and innovation at the corporate level, the prevailing market climate, though volatile, has been conducive to the outperformance of such high quality, growth profiles. Capex and consumption patterns in many end markets have been disrupted by COVID-19, but may ultimately split across more distinct or divergent trajectories.

However, it is equally important to consider and monitor the other side of the coin, namely, those industries where fundamental competitive dynamics, barriers to entry, and regulatory frameworks are onerous, and market-listed participants struggle to meet our investment and conviction thresholds. The corresponding underweight stances are deliberate sources of active risk and must be rationalized and calibrated accordingly.

Take, for example, the banking industry, in which we have long had an underweight. Despite recently skyrocketing risk premia seen across the Energy and Airlines industries, it is Banks that remain the single largest block of return-constrained companies within the developed markets ex-US universe.

In 2009, former Federal Reserve Chairman Paul Volcker caustically quipped that "the only thing useful banks have invented in 20 years is the ATM". Barclays Bank launched the first operational cash dispenser in 1967, giving the European banking sector claim to this pioneering mantle. Since then, however, Europe certainly cannot be excused from Volcker's broader argument that "I have found very little evidence that vast amounts of innovation in financial markets in recent years has had a visible effect on the productivity of the economy". Traditional banking activities should be, in the information era, an inherently commoditized business. Low regulatory appetites for other risk-taking business lines are reflected in high capital adequacy requirements and regular stress tests which show little sign of abating.

At a macroeconomic level, recent events and monetary response have ensured that interest rates are shifting further along the "lower for longer" spectrum towards the realm of QE Infinity. In addition to the prolonged net interest margin pressure this exerts (lending-deposit spread), the medium-term credit risks are now far more elevated than at the turn of the year. For now, governments and monetary authorities have essentially underwritten and backstopped the most severe liquidity and solvency risks in the economy. However, as these support programs expire, the creditworthiness of many businesses and households may be structurally different than those modeled and assessed previously.

In fact, evidence from the past decade (Exhibit 1) shows that even before the latest round of stimulus, systemic levels of aggregate indebtedness in Europe are high on a GDP-denominated basis. If anything, it appears that government economic policy response has served to crowd out commercial borrowing levels in the private segments. Another chronic overhang for private lenders; minimal pricing power coupled with volume headwinds.

The question that we attempt to address when constructing our portfolio is, are the quasi-permanent headwinds facing European banks (dismal pricing power, anemic demand, unfavorable cost structures, "political football" status) already embedded in low forward valuations (substantially below book value in many cases)? Relative valuations versus the broader market are undeniably cheap, but many banks are only trading at a modest

EXHIBIT 1: DEBT AS A PERCENTAGE OF GDP

2008	Household	Corporate	Government	Total	2018	Household	Corporate	Government	Total
Belgium	56.4	149.0	127.5	332.9	Belgium	58.7	170.2	137.1	366.0
France	55.6	118.6	101.2	275.4	France	57.1	142.9	112.4	312..4
Germany	55.7	54.8	83.5	194.0	Germany	53.3	54.1	76.1	183.5
Greece	65.5	66.8	176.6	308.9	Greece	60.0	65.1	186.0	311.1
Ireland	93.2	197.9	112.5	403.6	Ireland	52.1	259.3	75.3	386.7
Italy	43.2	81.0	127.0	251.2	Italy	41.2	73.5	138.9	253.6
Netherlands	115.8	165.7	78.0	359.5	Netherlands	110.0	175.9	76.5	362.4
Portugal	86.1	134.0	143.0	363.1	Portugal	72.6	111.7	146.7	331.0
Spain	77.8	124.3	123.0	325.1	Spain	64.5	104.4	130.8	299.7
UK	84.9	87.9	88.8	261.6	UK	83.3	83.0	107.3	273.6

= Debt/GDP greater than 90%   = Debt/GDP greater than 240%

Source: Berenberg, Eurostat

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discount to their own absolute long-term averages. Cheapness does not exist in a vacuum and there are few readily identifiable catalysts around which to build conviction. In our opinion, banks would have to start providing evidence that they have over-provisioned too cautiously against non-performing loans or show a greater appetite for expensive and politically-onerous cost savings. One final favorable top-down tail risk could be the establishment of "bad banks" in the Eurozone to sequester toxic assets from banks' balance sheets, immunize their legacy effects, and provide a more solid foundation for remaining businesses. Interestingly, if past is prologue, we recall that Japanese banks outperformed in the wake of similar, long-gestation clean-up initiatives in 2002.

So, are we poised for a similar value-centric rally of European banks? Many broader Japanification precedents appear to be playing out in Europe. However, we currently find that the necessary reforms and conditions for financial sector rehab remain elusive. Ultimately, any such move may only represent a consolidation phase within a longer-term absolute downtrend.

Furthermore, if one is tempted to play such deep Value recovery, it would arguably be more effective to do so via a geographically diverse factor or sector ETF. In a relatively concentrated portfolio of fewer than fifty holdings, we need to weigh the opportunity costs of diluting exposure to self-sustaining high ROE (return-on-equity) compounders in other sectors. Back-testing results show that the power of such compounding metrics tends to be underestimated on a recurring basis, particularly in Europe.

Exogenously, European banks are hostages to stagnant interest-rates, on average, more sensitive to Treasury yield moves than U.S. banks. From a bottom-up perspective, a reluctance and inability to meaningfully repair their balance sheets a decade ago continues to haunt them. From a capacity perspective, Europe is over-banked, a situation tied to a lack of true cross-border consolidation and is therefore fraught with nationalistic political deadlock.

Finally, alternative digital and transaction platforms are gaining traction. The Saudis were famously astute in acknowledging that "The Stone Age didn't end because the world ran out of stones, and the age of oil will not end because we run out of oil." Similarly, from a fundamental perspective, abundant cheap money and the availability of credit may be the least of banks' headaches.

About our firm:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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