TEMPLE BAR
Investment Trust Plc

Temple Bar quarterly newsletter

Issue 8 – May 2023

Dear investor,

Welcome to the eighth issue of Temple Bar's quarterly newsletter. In this quarter's feature article, Ian Lance explores the continuing investment attractions of the modern banking business model. One of the key features of the last quarter was the sudden demise of several banks, most notably Silicon Valley Bank (SVB) and Credit Suisse. As the Temple Bar portfolio has holdings in NatWest, Barclays, Standard Chartered and Citigroup, Ian takes the opportunity to explain why he and co-portfolio manager Nick Purves believe selective banks can still represent very profitable long-term investments.

We also include information about a recent video update recorded by Nick for the Doceo investment trust platform in March, news of the trust's recently issued annual report and a curated selection of recent press coverage.

We remain open to your feedback on all matters relating to the trust. Please feel free to email us at TempleBar@Redwheel.com or by any of the other means of contacting us that are detailed on our website. All the best for the year ahead.

The Temple Bar team

The enduring investment appeal of banks

One of the key features of the last quarter has been the sudden demise of several banks, most notably Silicon Valley Bank (SVB) and Credit Suisse. Despite the fact that there were company specific errors that brought about these events, some fund managers well known for their quality growth style of investing, have suggested that this proves that banks as an industry are 'uninvestable'. Of course, many of the same people were saying the same things about the energy sector a few years ago and this has subsequently been the best performing sector for the last two years and the only sector to produce a positive absolute return in 2022.[1] Indeed, some of our most profitable investments have been in industries which have become so hated that many fund managers state that they will not invest in them regardless of valuation. As the Trust has holdings in NatWest, Barclays, Standard Chartered and Citigroup, this quarter's letter will seek to explain what is different about banks' business model and why we believe they can still represent very profitable investments.

What is different about the banking business model?
There are several things that make banks different from standard industrial businesses. At its simplest, a bank's profits are derived by taking in deposits on which it pays interest, and then lending them out at a higher rate of interest. The difference between the rate paid on the deposits and the rate charged on the loans (known as the net interest margin) accounts for a substantial proportion of most banks' profits but there are two implications of this business model.

Firstly, since a large part of a bank's funding comes from deposits, it does not have to raise as much equity as a standard industrial company. If we take the example of NatWest, its equity capital is £36.5bn whilst its funding via deposits is much larger at £470bn. The company has made loans of £373bn and therefore critics of the banking business model will point to the inherent leverage, whereby equity represents only 10% of the loan book.[2]

The second major difference is that banks are susceptible to a 'banking run' in the way that other companies are not. This is an event where depositors lose confidence in a bank and take their money out in a very short period of time (this was what caused SVB to fail).

Two final criticisms of the banking business model are that the returns are not high enough to compensate investors for the risks highlighted above and that the business model is now being disrupted by new entrants to the industry known as fintechs. Let us now dig a little deeper into each of these criticisms.

No evidence that banks are being disrupted by fintechs
The appropriately high regulatory oversight of the banking and broader financial sectors makes it very challenging for new companies to take meaningful share from incumbent banks. This perhaps insulates banking from the threat of obsolescence more than in some other sectors, where competition is fiercer and barriers to entry are lower. Whilst consumers will frequently switch between broadband providers or utility companies, research has revealed British citizens are more likely to divorce than to switch bank accounts, even if they are unhappy with the service they receive.[3] Whilst many fintechs have been launched in the past decade to much fanfare, the core banking landscape in most countries, and certainly the UK, has not shifted much as a result: NatWest, a large UK retail bank that the trust owns, had 19 million UK customers in 2022, the same number it had in 2016.[4] The story is the same with the other large UK banks, with scant evidence of mass customer churn.[5]

What is happening, and a point that investors afraid of fintech innovation forget, is that banks are simply incorporating and adapting fintech approaches to change the way they interact with their customers. This not only neatly heads off the risk of technological obsolescence – with the well-funded banks able to put substantial resources into such efforts – but it also makes these processes more pleasant and efficient for customers, likely increasing consumer experience and retention, and lowering the cost of service delivery. At NatWest, for example, there were 10.1 million active digital users in 2022, with 8.9 million on the mobile app (more than double the 4.2 million seen in 2016) and 63% of all retail customers now exclusively using digital channels, requiring no human input whatsoever (up from 58% just two years ago).[6]

At the same time, where customers need further support, the bank offers AI virtual assistance, resulting in just under 50% of customers resolving their issue with no need for human (read: expensive) intervention. In 2022, this amounted to a little less than 5.2 million customer interactions with NatWest which were started, conducted and resolved fully autonomously, with no people from NatWest customer support involved.[7] With the well-heralded introduction in 2023 of newer, more capable and enterprise-ready AI tools, it seems highly likely that this rate may continue to improve, rewarding shareholders and customers with the improved productivity that novel technologies bring. The same story is true across the wider banking sector where retail banking customers and investors have come to expect their banks to keep up the pace of improved technological capabilities. In such an environment, it is puzzling to accuse these businesses of ignoring, or being incapable of responding to, technological innovation.

Are returns really too low to compensate investors?
Quality growth investors are sometimes guilty of a sleight of hand in which they claim that a consumer product business, for instance, is a better business than a bank because it makes a higher return on equity. Whilst this is factually correct, it is arguably disingenuous because it fails to consider the valuation paid to access those returns.

Think of it this way: a landlord who purchased a house for £100,000 forty years ago, and now earns rent of £33,000 on it has a yield of 33%. The new buyer at today's market value of £825,000 is making a yield of 4% not 33%. The same maths applies to stock market investments. Companies such as Procter and Gamble are often lauded as 'wonderful businesses' because of their high return on equity and it is fair to acknowledge that in 2022 it made $15bn on an equity base of $46bn which is an impressive return on equity of 32%.[8]

The omission here is that Proctor & Gamble is valued at $355bn in the stock market today and hence the investor who pays this starting price does not get to make a 32% return on equity but only 4% ($15bn/$355bn) because they are paying 7.5x shareholders equity for the privilege of being a Proctor & Gamble shareholder.

1 Bloomberg as at 12 April 2023
2 NatWest Annual Report and Accounts, 2022
3 You are more likely to get divorced than to change your bank", Fintech Finance News, 8 Jan 2019
4 NatWest Group Annual Report and Accounts, 2022 & 2016
5 By contrast, six years after Netflix was founded in 1997, Blockbuster's same-store sales growth had turned negative, beginning its inexorable decline

6 NatWest Group Annual Report and Accounts, 2022
7 NatWest Group Annual Report and Accounts, 2022
8 Procter and Gamble Annual Report and Accounts 2022

When businesses change hands at fractions (or large multiples) of their book value, the price paid for ownership can amplify or dampen the returns investors ultimately reap. In the same way that we would argue that investors bid away 30% returns on equity by paying eight times book value for a company like Proctor & Gamble, we would argue that investors can generate superior returns by buying a 10% return on equity company like Standard Chartered at half of its book value (thus generating a 20% earnings yield on their money). Simply dismissing a business model out of hand, without paying attention to the price at which that business is on sale, is an abdication of one of the key responsibilities of an active manager.

Assuming all banks are the same is either lazy or misleading
Having had an unpleasant experience with a cheap bottle of heavily oaked Australian Chardonnay, none of us would conclude that all white wines are undrinkable. So why would anyone do that with businesses? A key job of an active fund manager is to find and own the very best investment opportunities that their relevant area of focus affords them. Dismissing a large number of companies, based on an assessment of the returns historically delivered by the sector in which they operate, would again seem to overlook this imperative function.

Even if banks have performed poorly in broad terms, as measured by an appropriate index of choice, that is no reason to conclude that all banks have performed poorly and that the banking business model is flawed. There are, in almost all circumstances, standout performers to choose to be invested in.

An easy example in the banking industry is US behemoth Wells Fargo, which has earned an average 13.3% return on equity in the 23 years since 2000, including the catastrophic industry experience in the Financial Crisis (during which it still made money).[9] Indeed, if investors both recognised this impressive performance, and took advantage of the low price-to-book opportunity offered by the crisis, buyers in 2009 would have earned a total annualised return of 17.7% over the subsequent five years.[10] Dismissing banks outright is to dismiss these return opportunities, not something we feel any need to do.

[9] Bloomberg as at 31.03.23
[10] Bloomberg as at 31.03.23

Looking at leverage alone is too simplistic
The counterpoint raised by some investors is that, whilst it is true that these high return opportunities do exist for bank investors, they do not sufficiently reward shareholders for the risks they bear, given the highly leveraged nature of the business. We disagree. Whilst it is no doubt the case that leverage brings with it risks, it is important to consider what companies do with the proceeds of that leverage, and how they employ it in the context of a wider business model, before reaching conclusions about how risky that borrowing really is. After all, freight trucks have much larger engines than Ferraris, but don't travel at speeds that endanger the driver nearly as much.

For example, a company that borrows money to purchase specialised equipment and construct a factory that can be employed only for the manufacture of a single product category, seems to us to be taking far more risk with that money than a bank, which deploys its borrowings across a broad array of assets, many of which are high-quality, low risk and deeply liquid, tradeable almost instantly to meet client redemptions.[11]

One need only look at default rates by sector to observe that banking has one of the lowest cumulative default rates over a ten-year horizon. Bank default rates stand at 4.2%, whilst durable consumer goods (25.6%), retail (24.3%) and even healthcare (10.4%) all sport far higher risks for investors.[12]

It is true that leverage requires caution, and that bank management teams that do not proceed with that caution can wound shareholders, occasionally fatally. The same, however, is true of all business models, and bank management teams seem to have internalised the lesson more than most, if a fifty-year record of corporate bankruptcies is any guide.

How susceptible are banks to runs on deposits?
It is also finally worth rebutting the claim that even healthy, well-managed banks can be wiped out by bank runs, a topic which is top of mind in light of the recent SVB debacle. In the modern central bank system in which most economies operate, this is simply not the case. To paraphrase the famous Lombard Street maxim of Walter Bagehot, the function of central banks in times of crisis is to lend freely, against good collateral, at penalty interest rates.[13] If you have intelligently managed your banking operation, and have sufficient quality on the asset side of your balance sheet, then you can borrow against these high-quality assets in times of distress, and can afford to pay the penalty rates for doing so. A glance at the influx of deposits into the strongest banks over the past few weeks, in the wake of the SVB concern, is a worthwhile point of corroborating evidence that strong banks benefit at the expense of the weak.

Conclusion
We believe that there is a clear investment case for selected, well-managed banks who are able to respond to technological change with the dynamism demanded of a start-up, whilst at the same time managing their balance sheets with the conservative caution that is needed when employing borrowed money. The banks that we own, in our view, meet and exceed these requirements, and offer investors, at current valuations, excellent prospects for future returns.

In taking this view, it would appear that we are in quite good company, since Warren Buffett's Berkshire Hathaway has in the past owned banks such as Wells Fargo, JP Morgan, Citigroup, Bank of New York Mellon and US Bancorp. Bank of America is currently its second largest position after Apple.

If banks are 'uninvestable', it would appear that no-one has bothered to tell the Sage of Omaha.

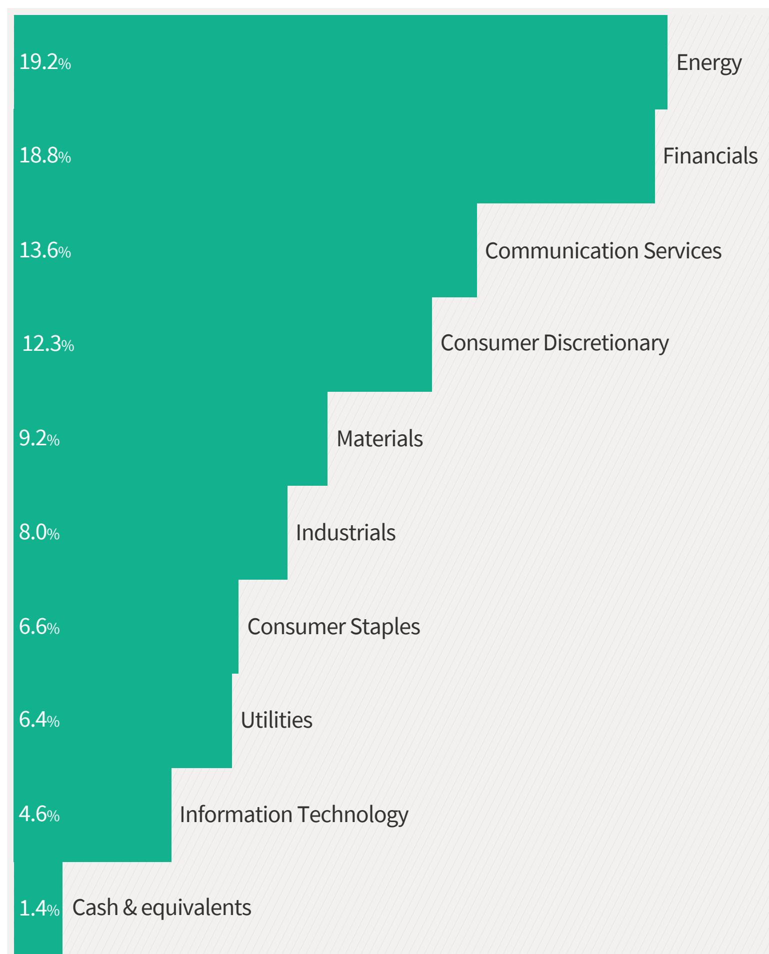
[11] The importance of considering the risks of the business model as well as those of the capital structure can be amply demonstrated by looking at what happens to the equity capital of companies with unprofitable economics. Merely observe the plethora of unprofitable tech companies that listed in the frenzy of 2021, only to be worth 1% of their peak value today. Business model, as well as funding structure, matters for investors.
[12] Moody's Annual Default Study, 2021
[13] Walter Bagehot, Lombard Street: A description of the Money Market, 1873

The Temple Bar portfolio

Data as at 31 March 2023

Top 10 equity holdings	(%)
BP	7.57
Shell	6.86
Marks and Spencer Group	6.58
Centrica	6.39
NatWest Group	5.43
Standard Chartered	5.42
Pearson	5.20
ITV	4.95
TotalEnergies SE	4.73
International Distributions Services	4.47
Total	**57.6**

Sector analysis



Financial data

Total Assets (£m)	820.87
Share price (p)	231.0
NAV (p) (ex income, debt at mkt)	243.1
Premium/(Discount), Ex income (%)	-5.23
NAV (p) (cum income, debt at mkt)	245.7
Premium/(Discount), Cum income (%)	-6.37
Historic net yield (%)	4.05
Net gearing (%)	6.57

Dividend history

Type	Amount (p)	XD date	Pay date
4th interim	2.50	10.03.23	31.03.23
3rd interim	2.50	10.12.22	30.12.22
2nd interim	2.30	10.09.22	30.09.22
1st interim	2.05	10.06.22	30.06.22

Performance (total return)

Cumulative returns (%)

	Share price	NAV	FTSE All-Share
1 month	-5.5	-6.1	-2.8
3 months	5.8	5.8	3.1
1 year	4.1	7.0	2.9
3 year	71.2	81.6	47.4
5 year	16.6	17.1	27.8
10 year	52.0	59.4	75.9
Since 30/10/2020	81.1	75.8	43.3

Rolling 12 month returns (%)

	Share price	NAV	FTSE All-Share
31.03.22 - 31.03.23	4.1	7.0	2.9
31.03.21 - 31.03.22	5.0	6.3	13.0
31.03.20 - 31.03.21	56.7	59.8	26.7
31.03.19 - 31.03.20	-39.0	-41.0	-18.5
31.03.18 - 31.03.19	11.6	9.3	6.4

Important information

Past performance is not a guide to the future. The price of investments and the income from them may fall as well as rise and investors may not get back the full amount invested. Forecasts and estimates are based upon subjective assumptions about circumstances and events that may not yet have taken place and may never do so.

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment. Nothing in this document should be construed as advice and is therefore not a recommendation to buy or sell shares. Information contained in this document should not be viewed as indicative of future results. The value of investments can go down as well as up.

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Other news

UK Investor Magazine event presentation

Ian Lance presented at a UK Investor Magazine virtual event in March, outlining how the trust is positioned to capture the UK value opportunity. You can watch a recording of his presentation and download the slides via the link below.

Watch and download now >
https://ukinvestormagazine.co.uk/temple-bar-investment-trust-presentation-march-2023/

Nick Purves video
March 2023

In this video, Nick provides an update on recent performance, current strategy and an outline of the investment case for two of the portfolio's core holdings, Shell and Barclays.

Watch now >
https://www.templebarinvestments.co.uk/nick-purves-video-update-march-2023/

Annual report and accounts

Temple Bar's annual report and financial statements for the year ended 31 December 2022 were published on 23 March. Shareholders for whom we hold correspondence details should already have been notified of this, but you can download a copy of the annual report from our website (templebarinvestments.co.uk) or request a copy by emailing us at TempleBar@Redwheel.com.

Annual General Meeting

Temple Bar's Annual General Meeting will this year be held at 25 Southampton Buildings, London, WC2A 1AL on Tuesday, 9 May 2023 at 12:30pm. We realise that this newsletter may arrive with you after the AGM has taken place, but shareholders are welcome to attend in person where you will be able to hear a presentation from our portfolio managers and meet the board of directors.

Temple Bar in the media

Positive media coverage of Trust continued during the first three months of 2023, with Ian and Nick contributing to a range of publications, including the Daily Mail, Bloomberg, This is Money, Investors' Chronicle, and appearances on Sky News and Bloomberg's Merryn Talks Money podcast.

Time to invest in the UK
– Shares Magazine

Why there's more to come from Temple Bar
– Investors' Chronicle

What the 'resurgence' of value stocks means for investors
– FTAdviser

The potential benefits of share buybacks
– Sky News

Why you should stop selling UK equities
– Merryn Talks Money podcast

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