ticker

Investing in Financials with the Goal of Minimizing Downside Risk

As a result of the 2008 financial crisis, investors are still cautious about banking stocks. However, for Dave Ellison and Ryan Kelley, co-managers of the Hennessy Large Cap Financial Fund, the financial world provides plenty of opportunities. Running a concentrated portfolio, they focus on choosing the companies with the right business models, repeatable earnings, and management teams with the ability to withstand the storms in the credit and interest rate cycles.

What is the history and mission of the fund? How does it differ from its peers?

The Hennessy Large Cap Financial Fund was started in 1997. The mission of the fund is to run a diversified, large-cap, financial services portfolio. It is a performance-driven fund.

One of our main differentiators is that we have stayed more concentrated in large-cap banks, despite having investments in other financial companies. We don't try to replicate an index. Instead, we try to find the best companies that we believe will bring solid returns to the shareholders.

What are the benefits of investing in such a fund?

Our goal has been to minimize downside risk when times are difficult and to provide investors with a measured and thoughtful group of companies that we believe will do well in the good times.

The hallmark of a good economy comes from a healthy system. We had huge problems from the credit side in 2008-2009, but afterwards banks have come a long way in creating much stronger balance sheets, establishing better controls, and de-risking their business models. So, we can evaluate the companies from a pure price-to-earnings and fundamental basis and not worry too much about asset quality at this point.

What core beliefs drive your investment philosophy?

We believe that four major factors drive the performance of companies - the credit cycle, the interest rate cycle, the regulatory cycle and the accounting cycle. We focus mostly on the credit cycle, because it is the most important driver.

Next we look at earnings, as we acknowledge that the sustainability and the repeatability of these earnings are important for a company to withstand the storms of credit, interest rate, regulatory and accounting changes.

Would you explain your view on analyzing the credit cycle?

Between 2008 and 2011 we went through a significant credit cycle, where home prices dropped, defaults increased, and foreclosures were too common. That is a bad thing for the banks, because they own mortgages. If they have to write the assets off, that creates losses, higher provisions and expenses.

So we look for changes in underwriting that may lead to rising default rates and the costs associated with these defaults. That's why we follow the companies with attention to detail and talk to them quarterly. We look at 400 to 500 companies every quarter to get an update of what's happening in the marketplace in terms of the pricing and underwriting standards. That's, obviously, a big driver for these companies and we saw that in the last down cycle.

For instance, back in 2015, oil prices dropped quickly. In the third and fourth quarters of 2015 there was a lot of scrutiny on banks, especially the large banks, to figure out how exposed they were to the oil industry. Huge banking losses were expected if oil companies, drillers, and exploration & production players went bankrupt. However, the reality was that many banks had little to no exposure. JPMorgan, for instance, had loan exposure of 1% to that type of lending.

At the end of the day, losses were minimal over the next four quarters, but in some cases stocks dropped 50 percent. The recovery in those stock prices has been pretty phenomenal for the last two years. That's a specific case, where

David Ellison,
SVP, Portfolio Manager

David Ellison brings 30 years of investment management experience to Hennessy Funds, and he has been recognized by Morningstar as the most tenured mutual fund portfolio manager in the Financial Services sector. Prior to joining Hennessy Funds, Dave served as President & CIO of the FBR Funds, where he launched and oversaw the line-up of ten FBR Funds. Dave began his career at Fidelity, where he managed the Select Home Finance Fund, and he developed his investing discipline and strategy under the tutelage of famed value-investor, Peter Lynch. Dave received a BA in Economics from St. Lawrence University and an MBA from Rochester Institute of Technology.

Ryan Kelley, CFA
Portfolio Manager

Ryan Kelley brings nearly 20 years of financial analysis, trading and portfolio management experience to Hennessy Funds. Ryan serves as a Portfolio Manager of the Hennessy Small Cap Financial, Hennessy Large Cap Financial, the Hennessy Gas Utility Fund, the Hennessy Cornerstone Growth, Cornerstone Mid Cap 30, Cornerstone Large Growth, Cornerstone Value and the Hennessy Technology Funds. He began as an associate in corporate finance at FBR & Co., a leading investment bank headquartered in the Washington, D.C. area, and later joined their institutional equity research team. In 2005, Ryan became a member of the FBR Funds portfolio management team and transitioned to Hennessy Funds portfolio management when the firm acquired FBR in 2012. Ryan received a BA from Oberlin College. He is a CFA charterholder and member of both The Boston Security Analysts Society and the CFA Society North Carolina.

we had to pay attention to what the companies were showing and saying, not to what the market was doing or believing.

How does your philosophy translate into the investment process?

Every earnings season we look at 400 to 500 financial companies and focus on those with a market capitalization of more than $3 billion. Historically, we have invested only in U.S. companies and have not invested in foreign banks or financial companies.

We focus on growth in book value, because it is a critical way to measure financial companies. The banking business runs on the balance sheet and if the balance sheet isn't getting better, then we are not getting anywhere. Then we look at price-to-book and price-to-earnings ratios. We are valuation oriented and we don't want to buy the highest-priced stocks in the market.

The next step is looking for four types of criteria. First, we look for repeatable earnings, because they are a sign of well-run companies. Second, we look for companies with management changes, because when a poorly run company gets a new manager, there is the potential for a turnaround and repeatable earnings.

Third, we focus on companies in which there's been a difficult credit environment, and that either brings a new management or attention to detail in credit. Historically, credit has been the biggest driver in terms of earnings and stock prices, both on the upside and the downside.

The fourth type is the transformative merger or acquisition, where a company doubles in size and gets scope, market control and the ability to have repeatable earnings over time.

Overall, our process is driven by stock selection. There is a macro overlay as well, which is more related to the types of companies we might be invested in. Although the fund is primarily focused on large banks, we do invest in other financials based on macro trends. For instance, right now we have about a quarter of the portfolio in companies like MasterCard, Visa, and PayPal, which are not traditional banks.

Changing the portfolio in terms of composition and types of holdings is always a conscious decision. Because of the move in rates and the regulatory recalibration after the 2008 cycle, the way we invested in financial stocks has now changed. The ability to grow loans or make a margin has been diminished. So, we needed to move the portfolio towards new types of repeatable businesses that wouldn't be impinged by rates or regulatory overlays. We had to adjust a lot of our thinking because of the post-2008 regulatory and accounting changes

Could you highlight your investment process with some examples?

We've added or increased our exposure to names like Visa and MasterCard, because these are quasi-monopolies that are not sensitive to the credit cycle or regulatory changes. We've increased our exposure with the assumption that if there is a significant move up in interest rates, changes in the yield curve, or a significant regulatory change, they will be less affected and, therefore, their repeatable business model will remain intact.

We look for businesses that are able to sustain a level of consistent profitability and these businesses should be in the right market or mindset. Although the regulatory cycle has been very harsh, there has been a regulatory moat put around larger banks, so we have kept them in the portfolio.

We recognize that the industry has changed significantly in the last decade and is in tremendous flux. Companies like Square, Lending Club, Alipay and Apple Pay are coming into the industry and disrupting it around the edges. Then, there are the crypto currencies. Combined with the Fed rate policy, there is an impact on the supply and demand of credit in the marketplace. There are international influences as well, so we are constantly looking at the competitive landscape, and we try to stay away from potential problems.

With the significant disrupters around the edge, we have to be mindful of how business models are changing. The bigger companies have the flexibility, the earnings, and the ability to get through these challenges and reinvent themselves or become part of the new regime. Now we are in an environment where rates aren't rising anymore, so leverage isn't as valuable, and we had to recalibrate.

Many of the companies have been in the fund for a long time, but we re-examine them every quarter when we look at their earnings. Every quarter we decide if we want to keep them. That's part of our process - going through every name every quarter and looking at the fundamentals.

Would you give us an example from the banking industry and your research process?

We'll look at Bank of America this quarter to see if there is any loan or deposit growth and to compare it with the industry. Next, we'll look at growth in tangible book value and the asset quality, both in new and old loans, as well as how well reserved the bank is in absorbing any losses.

Then we look at revenue and expenses, or how efficient the company is versus its peers. Different types of banks have different business models and varying degrees of the efficiency ratios and we look closely at that. Bank of America has been trying to rationalize its businesses, to cut costs where possible. Through the financial crisis there were many changes in the business and some aspects don't make sense any more. We like that the bank is doing a good job of controlling expenses.

We also examine the deposit and loan mix, because it dictates the margins going forward. A company with 100% in fixed-rate 30-year mortgages will not do well as rates rise, but a company with more variable rate mortgages, will ratchet up in such an environment. That's something we consider.

Once we review all these fundamentals, we focus on valuation. Bank of America is now trading at 11-12 times next year's earnings and, historically, that's very cheap relative to peers.

Overall, we think the industry moves together more than in previous years, because the level of rates and oversight has pushed everybody into the same types of products. So, we want to own companies with management teams that provide repeatable earnings and who can best deal with changes in operating conditions.

In essence, we are buying management teams with the assumption that we are going to hold these companies for a fairly long period of time. We have owned Berkshire Hathaway, Inc. for a while, as it fits the criterion of good management that's going to make better than average decisions over a period of time.

We also take into account valuation and changes in the fundamental outlook of the industry. Then we try to select the best managements in the industry. That's why we look at all the companies every quarter and closely follow what's happening.

We believe that knowing what's happening in the entire industry gives us an advantage over most people on Wall Street, because typical analysts on Wall Street follow 15 or 25 companies, not 300 or 500 like we do.

The financial industry isn't one that can significantly transform itself. This is a commodity industry that's been around for 1,000 years; it has seen the ups and downs of cycles and is very much tied to an Apple or a Facebook. They piggyback and prosper from those innovations.

It's very hard to outperform in this industry, and that's why focusing on minimizing downside risk is so important, especially when conditions get rough. Now we are entering a period, when it is more about rates, not that much about credit. With rates moving up, the price of bonds is falling, and we must be mindful of that.

Are you skeptical about regulations in the banking industry?

It's an industry that has been affected by lack of regulation. That's one of the reasons behind the current valuations. There is still concern that even with all the regulations, the companies may not be always acting in appropriate ways.

We very much support many of the regulations that have been put in place. Thanks to increased regulations, asset quality has improved immensely from10 years ago. In the last two years we've had the lowest levels of net charge-offs in 25 or more years. We have seen the benefits of regulation, and that helped investors become more confident about the banks in terms of underwriting standards. The large-cap banks are taking the biggest cost related to the changes.

On the flip side and not credit-related, it is disheartening to see growth in fake customer accounts, but I am hopeful that we won't see additional abuses. Overall, we believe that the current regulatory structure is good for banks and good for the long-term health of the economy.

What is your portfolio construction process?

Right now we have 26 names in the portfolio and, typically, we hold between 20 or 30 names. These are stocks that we feel are the better companies in the industry, or the ones that offer opportunity during the credit cycle, the interest rate cycle, the regulatory cycle or the accounting cycle.

We run a concentrated portfolio, and we don't worry about the indexes. We keep the individual position sizes no higher than 5% or 6%. We never have a position that's 10% of the portfolio, because when a stock reaches 6% or 7%, we would sell or trim down the position.

What are the other components of your buy-and-sell discipline?

We are not driven by hard price targets because, over time, that would make us too rigid. We could miss opportunities if we get rid of stocks too quickly. It takes a few months to buy a stock, and when we sell, we do it in increments. We are long-term investors, with the expectation to hold a stock for many years. In some cases, we may get in and out in half a year if conditions change and the underlying story doesn't make sense any more.

How do you define and manage risk?

Credit is the biggest risk that we focus on all the time. It doesn't change that dramatically, but the idea is to be mindful of the trends in the industry, and this is an industry that's tied to the macro economy with respect to loan growth, rates and credit.

Business model risk is also important. Although banks are in the business of lending and getting deposits, the models can vary dramatically in sources of income and the volatility of those sources. We tend to eliminate companies if their business model has inherent volatility, even if valuations are good. Also, we prefer not to focus on companies that rely solely on Wall Street for funding purposes.

So, for us risk is about a significant change in the earnings outlook, which boils down to the business model and the credit culture. That's why we focus mainly on those two aspects.

Valuation is important in the context of current events, but in a historical context, it's really not that relevant. What's truly relevant is to make sure that earnings don't suddenly drop dramatically because a certain portion of the business model blew up overnight. We don't like complexity in business models, while some leverage is tolerable.

Another risk measure is the construction of the portfolio itself. The limit of 5-6% in individual positions and the liquidity that we maintain are important. Cash can be an important tool to manage risk, and, at one point during the 2008-2009 credit cycle, we had north of 50% in cash, because the environment was not healthy for financial stocks.

Generally, we manage risk by staying conservative on the types of companies we own. The stock-picking process is one of elimination, not inclusion. By eliminating companies, we pick only the ones that we believe lack vulnerabilities over a cycle. Sometimes we eliminate a name primarily by looking at its business model. T

Hennessy Large Cap Financial Fund

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Source: Company Documents

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Please click here for a prospectus.

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Top ten holdings for the Hennessy Large Cap Financial Fund can be found here. Fund holdings and sector allocations are subject to change at any time and should not be considered a recommendation to buy or sell any security. References to other funds should not be interpreted as an offer of these securities.

Mutual fund investing involves risk; Principal loss is possible. A non-diversified fund, one that may concentrate its assets in fewer holdings than a diversified fund, is more exposed to individual stock volatility than a diversified fund. Investments are focused in the financial services industry; Sector funds may be subject to a higher degree of market risk. The Fund invests in medium sized companies, which may have limited liquidity and greater volatility compared to larger companies.

Price/earnings ratio is the market price per share divided by earnings per share. Book value is the value at which an asset is carried on a balance sheet. Price/book ratio is used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share.

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