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PROFESSIONAL

Polar Capital Global Financials Trust

Investment companies | Update | 7 June 2023

Avoiding mishap

After years of squeezed margins thanks to ultra-low interest rates, banks' profitability is increasing. However, higher rates have brought increased recession risk and have exposed inept risk management within some US regional banks.

The managers of Polar Capital Global Financials Trust (PCFT) were quick to cut exposure to more exposed areas of the sector, while increasing PCFT's weighting towards areas such as insurance and reinsurance, where the picture looks brighter.

Sentiment has turned against the sector once more, but as investors find assurance that the problems are stock specific rather than sector-wide, this could swing back in PCFT's favour.

Growing income and capital from financials stocks

PCFT aims to generate a growing dividend income, together with capital appreciation. It invests primarily in a global portfolio, consisting of listed or quoted securities issued by companies in the financial sector. This includes banks, life and non-life insurance companies, asset managers, stock exchanges, speciality lenders and fintech companies, as well as property and other related sub-sectors.

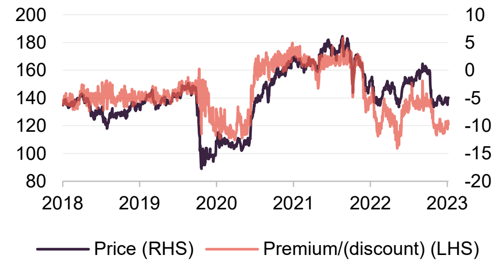
Year ended	Share price total return (%)	NAV total return (%)	MSCI ACWI Financials TR (%)	MSCI AC World TR (%)
31/05/2019	0.9	0.7	0.6	4.2
31/05/2020	(16.6)	(14.5)	(13.9)	7.5
31/05/2021	62.3	45.2	38.1	23.4
31/05/2022	(6.2)	2.3	6.8	5.1
31/05/2023	(8.8)	(3.9)	(3.9)	2.6

Source: Morningstar, Marten & Co

Sector	Specialist - financials
Ticker	PCFT LN
Base currency	GBP
Price	139.6p
NAV	155.4p
Premium/(discount)	(10.1%)
Yield	3.2%

Share price and premium/(discount)

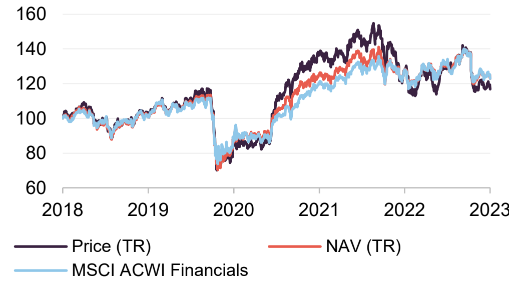
Time period 31/05/2018 to 05/06/2023



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/05/2018 to 31/05/2023



Source: Morningstar, Marten & Co

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Contents

Domicile	England & Wales
Inception date	1 July 2013
Manager	Nick Brind, John Yakas and George Barrow
Market cap	446.3m
Shares outstanding (exc. treasury shares)	319.675m
Daily vol. (1-yr. avg.)	688,643 shares
Net gearing	3.8%

Click for our most recent note

Click for an updated PCFT factsheet

Click for PCFT's peer group analysis

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Click to provide feedback to the company

Click if you are interested in meeting PCFT's managers

Click for links to trading platforms

Troubled banks

The past few months have been eventful within the financials sector. The collapse of Silicon Valley Bank (SVB) in March, was preceded by that of Silvergate, which had exposure to the cryptocurrency market. Two days after SVB failed, Signature Bank followed. The next big hit came from Credit Suisse and that was followed by First Republic.

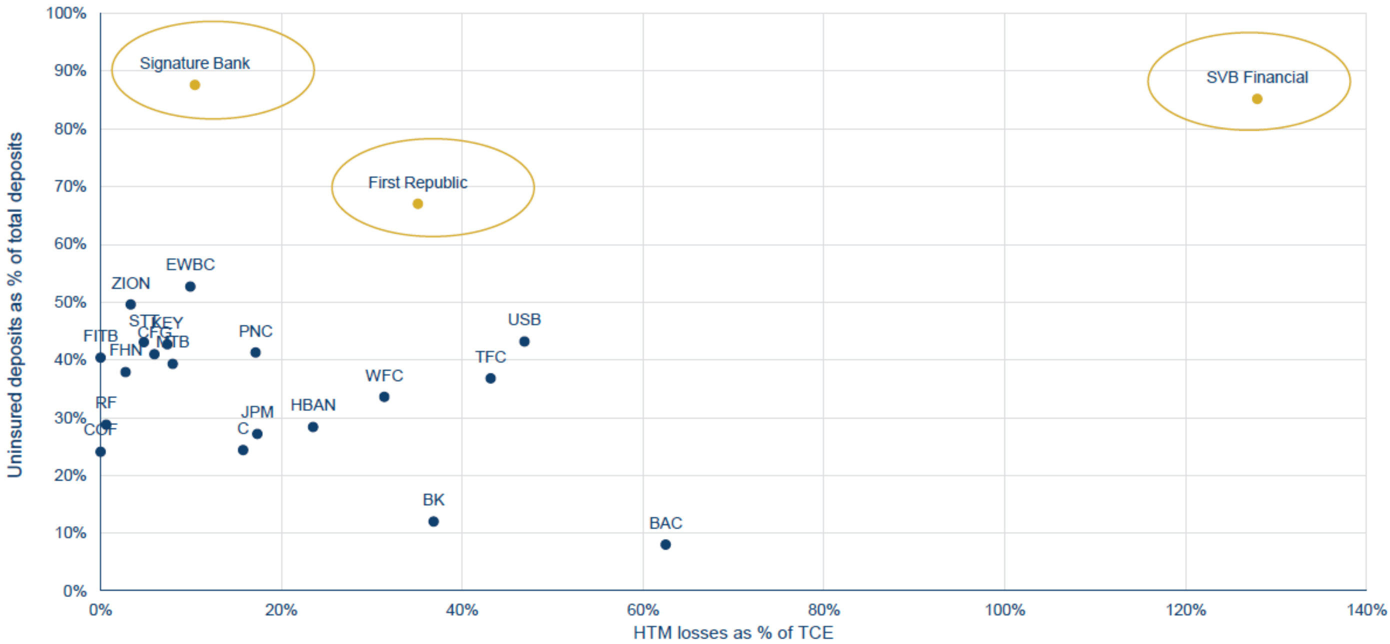
US banks that failed had a high proportion of uninsured deposits

Before writing this note, we talked to one of PCFT's managers – Nick Brind – about the situation. He pointed out that the three big US bank failures had one significant factor in common, a high proportion of uninsured deposits as a percentage of total deposits. Understandably this led to customers with deposits above the insured limit moving their deposits elsewhere.

$250,000 limit on deposit insurance

Nick feels that, while the outflow of deposits has stabilised, one way for the US authorities to reduce the risk that further runs are seen for whatever reason would be for Congress to approve an increase in state guaranteed deposit insurance (currently limited at $250,000 per depositor). However, there is political resistance to this, with Republicans in particular claiming that this would create a moral hazard whereby banks could take excessive risks, comforted that customers would be bailed out in the event of failure.

Figure 1: US held to maturity losses as a percentage of total capital employed versus proportion of uninsured deposits



Source: Polar Capital, based on company filings

California-based SVB, which had a strong specialism in lending to early-stage technology companies and private equity funds, was the 16th-largest bank in the US. In the face of a significant influx of cash, it mismatched its assets and liabilities, acquiring a portfolio of bonds which it then did not mark to market, on the grounds that it was going to hold these to maturity. As bond yields rose and the value of the bonds fell, nervous depositors began withdrawing funds. Soon it was forced to crystallise losses on its bond portfolio, as the run on deposits spiralled out of control. By 10 March, having failed to raise fresh equity, the Federal Deposit Insurance Corporation (FDIC) called time on the business, precipitating what was then the second-largest bank failure in US history (after Washington Mutual in 2008). SVB's US operations were sold to First Citizens BancShares and its UK business to HSBC. First Citizens BancShares later sued HSBC for poaching US staff.

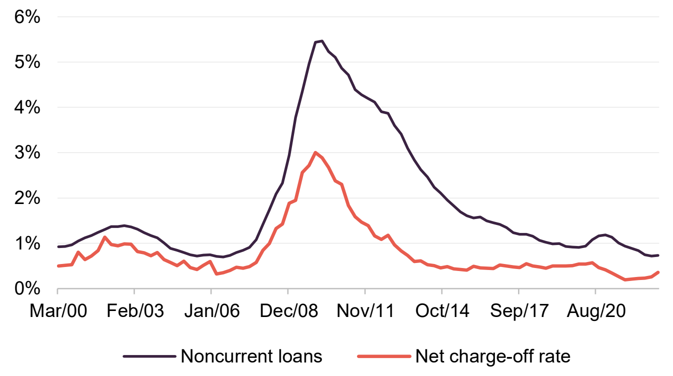
On 12 March, SVB's customers' deposits were guaranteed in full. However, depositors were already pulling money out of other lenders perceived as risky. New York-based Signature Bank, which had significant exposure to real estate lending as well as to cryptocurrencies, was shut down on the same day.

Credit Suisse also saw significant outflows of deposits

Long seen as accident-prone, Credit Suisse also saw significant outflows of deposits. Saudi National Bank, Credit Suisse's third-largest shareholder, ruled out a further injection of equity capital, unsettling Credit Suisse's customers. A SFR50bn credit line from the Swiss National Bank failed to calm nerves. Finally on 19 March, UBS agreed to buy Credit Suisse in a deal thrashed out by regulators that deliberately bypassed shareholders of both banks, but controversially wiped out the AT1 bondholders while giving some minimal value to equity investors which should have ranked below them. Unsurprisingly, holders of these bonds have filed a lawsuit against the Swiss financial regulator.

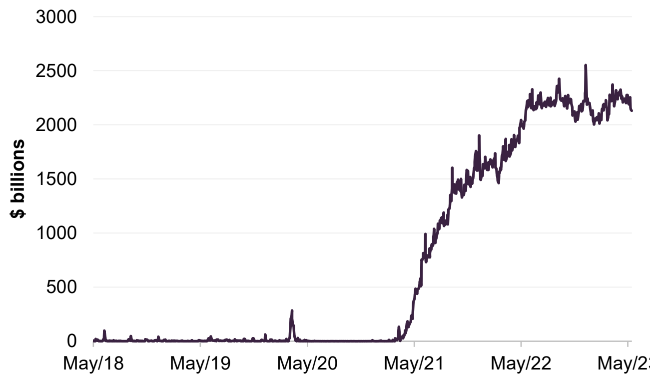
In the US, attention had turned to First Republic, which had significant exposure to mortgages. The bank's shares were falling sharply and, on 16 March, a group of 11 US banks agreed to deposit $30bn with the bank. Superficially, that seemed to do the trick, but on 25 April, First Republic revealed that $100bn of deposits were pulled from the bank during March, and the share price began to slide again. Over the weekend at the end of April, JPMorgan agreed to buy most of First Republic's assets as the FDIC shut the bank, with First Republic taking SVB's slot as the second-biggest-ever US bank failure.

Figure 2: US quarterly non-performing loans



Source: FDIC

Figure 3: US overnight reverse repurchase agreements



Source: Federal Reserve Bank of New York, treasury securities sold by the Federal Reserve in the temporary open market operations

PCFT had a 0.3% position in SVB ahead of its collapse, but the managers sold the entire stake before the news emerged of customer withdrawals. PCFT had no exposure to any of the other banks that collapsed.

The big banks are getting bigger

Nick notes that money has been flowing not only into banks that are perceived to be stable, such as JPMorgan Chase, but also into money market funds, which are said to have seen inflows of about $370bn over March and now hold about $5.3trn. A substantial proportion of that (about $2.2trn) has been parked with the Federal Reserve using its reverse repo facility. Effectively, this is taking money out circulation, which should be disinflationary.

It is too early to quantify the impact on smaller regional banks which have seen sharp falls in their share prices, such as PacWest, Western Alliance, Zion Bancorp and Comerica. PacWest cut its dividend aggressively and has sold off some of its loan book.

There are concerns about the impact on banks' balance sheets of slower growth (perhaps even a recession) as higher interest rates bite. However, sentiment towards the sector appears to be being driven by news headlines rather than fundamentals. News that Berkshire Hathaway has been selling bank stocks has not helped, for example. It is notable that, as at Q4 2022, non-performing loan rates remain at historically low levels.

Concerns about commercial real estate exposure

In the current environment of higher interest rates, it is thought that commercial real estate exposure may be the next problem area. Nick says that the biggest risk lies within smaller regional US banks and commercial real estate accounts for about 30% of their loan books. However, for the larger banks the exposure is more like low double-digit percentages of the book. These loans are secured against offices, retail, industrial and the like, but the majority relates to multi-family properties. Nick suggests that with typical LTVs in the 50–60% range, falling property valuations should be manageable for most banks.

The underlying story remains the same

As we summarised in our last note, PCFT's managers feel that investors' concerns about the overall health of the financial sector are overblown. They acknowledge the problems within the US regional banking sector, but have eliminated exposure to this area within PCFT's portfolio (from a low single-digit percentage of assets at the start of the year). Higher interest rates continue to be good news for banks' margins, although the cost of servicing deposits is rising.

Figure 4: JP Morgan (USD)

Source: Bloomberg

If anything, the events of the past few months have strengthened the investment case for the large-cap banks. For example, JPMorgan (PCFT's largest holding and one that the managers have added to in recent months, alongside Wells Fargo) looks set to profit handsomely from the First Republic deal. It has upgraded its earnings forecasts for 2023. Nevertheless, the managers suggest that it is being overly conservative in its assumptions on the profitability of First Republic's business, which could mean further upgrades to come. EU banks have also been seeing earnings upgrades, and here Credit Suisse seems to be perceived as a one-off problem.

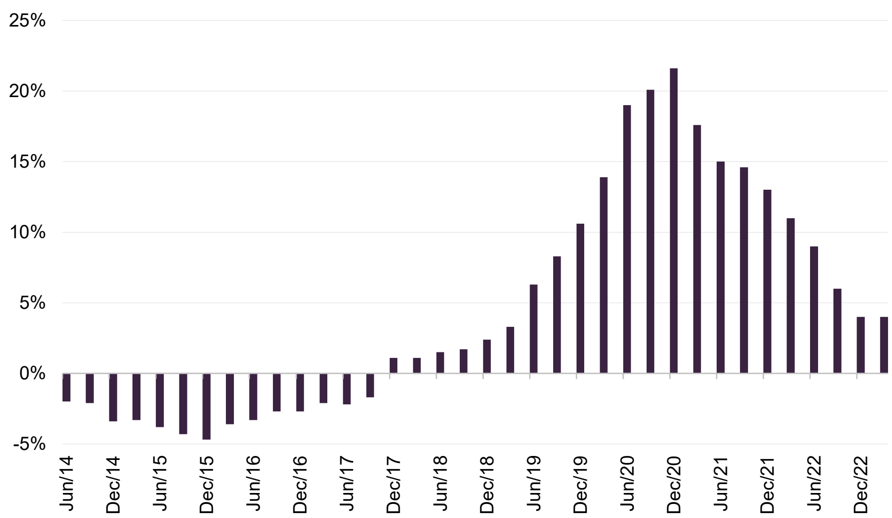
Nick expects that loan losses will rise, but this should be manageable given the more conservative lending standards adopted by banks in the wake of the GFC. Higher regulatory costs will likely have an impact at the margin.

EU banks have been hit by negative sentiment on the back of the US regional banks' problems and have derated. The managers note that European regulators have approved buyback plans for a number of European banks, suggesting that they retain confidence in the health of the sector. In the managers' view, banks are very cheap. Concerns about commercial real estate exposure should be less of an issue in the EU as they have a lower exposure as a percentage of their loan books and European banks have also hedged their interest rate risk so are unaffected by the sharp rises in interest rates on the value of their securities and loan portfolios.

The picture for insurance and reinsurance in particular looks good

Elsewhere in the sector, Nick notes that commercial insurance rates are still rising across most lines, albeit more slowly than they were. The picture for reinsurance looks good as the pool of capital has shrunk on the back of large losses, in particular Hurricane Ian (second only to 2005's Hurricane Katrina in terms of insured losses) and losses related to the invasion of Ukraine. Nick says that on average, reinsurance rates are up by 37.5% year on year.

Figure 5: Marsh global insurance composite pricing change



Source: Marsh McLennan. Note) year-on-year change

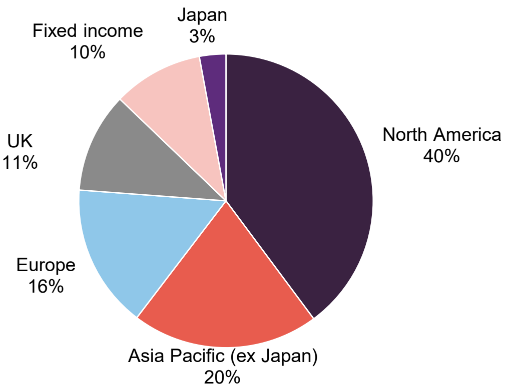
Asset allocation

At the end of April 2023, there were 90 positions in PCFT's portfolio and 94.9% of the portfolio was in stocks with market caps above $5bn (even more than was the case six months earlier). PCFT had an active share of 67.8% relative to the benchmark at end April 2023.

Since end October 2022 – the data that we used when we last published a note on PCFT – the trust's exposure to fixed income has risen, funded largely by a reduction in its North American banks exposure. In addition, payments firms have been reclassified from software to financial services and the managers have added to this area as well as to PCFT's insurance weighting. The managers have shifted the emphasis of the portfolio further towards larger-cap companies.

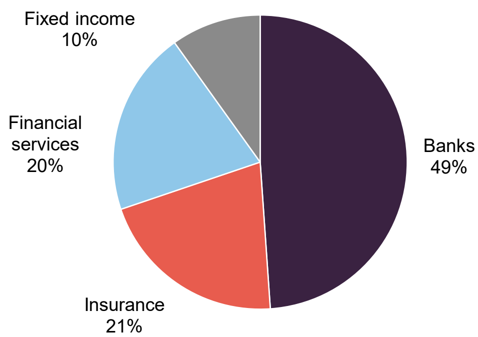
PCFT's managers added to fixed income positions during the LDI-triggered selloff last September and again more recently. PCFT's exposures in this area include AT1s and other bank capital, but it did not have exposure to Credit Suisse's AT1s.

Figure 6: PCFT geographic exposure as at 30 April 2023



Source: Polar Capital Global Financials Trust

Figure 7: PCFT sector exposure as at 30 April 2023



Source: Polar Capital Global Financials Trust

Top 10 holdings

Since 30 September 2022 (the data we used for the last note), DBS Group, Toronto Dominion, and PNC Financial Services have dropped out of the list of the 10 largest holdings (but are still sizeable holdings) and have been replaced by Visa, AIA, and Mastercard (all of which are longstanding positions within the portfolio).

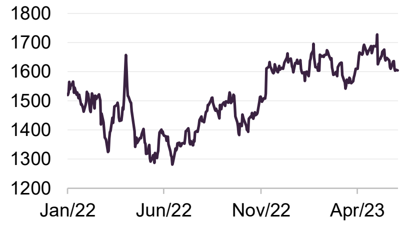
Figure 8: Top 10 holdings as at 30 April 2023

	Country/region	Subsector	30/04/2023 (%)	30/09/2022 (%)[1]	Change (%)
JPMorgan	United States	Banks	6.5	4.1	2.4
HDFC Bank	India	Banks	4.2	3.7	0.5
Chubb	United States	Insurance	3.6	4.1	(0.5)
Berkshire Hathaway	United States	Diversified financials (insurance)	3.5	3.4	0.1
HSBC	UK	Banks	3.2	2.2	1.0
Bank of America	United States	Banks	3.1	4.3	(0.8)
Wells Fargo	United States	Banks	3.1	3.5	(0.4)
Visa	United States	Financial services (payments)	2.8	n/a	n/a
AIA	Hong Kong	Insurance	2.7	n/a	n/a
Mastercard	United States	Financial services (payments)	2.5	n/a	n/a
Total			35.2		

Source: Polar Capital Global Financials Trust. Note 1) Percentage of gross assets

We have discussed most of these companies in previous notes.

Figure 9: HDFC (INR)



Source: Bloomberg

Figure 10: AIA (HKD)

Source: Bloomberg

Up to date information on PCFT is available on the QuotedData website

HDFC

HDFC is the leading private sector bank in India with a market share of about 10% of deposits and 83m customers. HDFC's share price was hit when the Indian Finance Minister announced a new tax on insurance premiums in February 2023's budget. However, good results published in April 2023 helped restore confidence. Revenue for the accounting year that ended 31 March 2023 was up 16% year-on-year and profit before tax was 21% higher.

To some extent, HDFC is riding the wave of a stronger Indian economy (loss provisions fell by 21%), but it is also taking market share. HDFC has a strong balance sheet, with a Tier 1 Capital ratio of 17.1%.

The managers are also encouraged that the planned merger of HDFC and Housing Development Finance will proceed in July.

AIA

PCFT has no direct exposure to China, but the managers are exploiting the recovery in China's economy linked to the abandonment of previous COVID-related restrictions through positions in stocks such as Hong Kong-based life insurer AIA.

AIA's Q1 2023 business growth figures were very strong, with a 28% uplift in the value of its new business, including double-digit growth from its Chinese operations. This should receive a boost in future periods as AIA has secured permission to operate in Henan (China's third-most-populous province) for the first time.

Performance

The drivers of PCFT's long-term performance have been discussed in earlier notes. These include the impact of the pandemic panic in March 2020 and the subsequent recovery. The sell-off in highly-rated growth stocks hit returns early in 2022; PayPal was a notable contributor to the fall in PCFT's relative performance over that period, for example. More recently, the trust's returns have matched those of the MSCI ACWI Financials Index more closely.

SVB's collapse occurred around the time of the brief spike on 9 March 2023, but this is likely a timing issue. As mentioned above, PCFT only had minimal exposure to SVB ahead of its problems becoming apparent, and the position had been sold before the stock ceased to trade.

As Figure 12 shows, PCFT has beaten its benchmark by a decent margin since it was reconstructed in April 2020, and up to the end of May 2023, the sector had outperformed the wider market. As we discuss in the next section, the setback in the banking sector over the past few months has contributed to some modest discount widening for PCFT.

Figure 11: PCFT NAV total return relative to MSCI ACWI Financials

Source: Morningstar, Polar Capital, Marten & Co

Figure 12: Cumulative total return performance over periods ending 31 May 2023

	3 months (%)	6 months (%)	1 year (%)	3 years (%)	Since 22 April 2020[1] (%)	5 years (%)	Since launch (%)
PCFT price	(14.1)	(11.5)	(8.8)	50.2	38.7	16.7	79.6
PCFT NAV	(9.9)	(8.0)	(3.9)	60.7	42.7	22.9	102.2
MSCI ACWI Financials	(9.5)	(8.4)	(3.9)	53.1	41.8	22.9	108.8
MSCI AC World Index	1.0	(0.6)	2.6	44.4	33.0	49.0	269.5

Source: Morningstar, Marten & Co. Note 1) 22 April 2020 was the date of PCFT's reconstruction- see page 11. Note 2) Based on data supplied by the manager, the return on the portfolio since launch has been 114.4%. This return adjusts for the dilutive effect on NAV returns of PCFT's subscription shares.

We have made the point in past notes that PCFT was established in part to provide UK-based investors with an alternative to a narrow group of relatively unexciting domestic financial stocks. UK banks have been re-rated somewhat over the past year or so as value-style investing has returned to favour. The longer-term picture of considerable outperformance by PCFT remains compelling, however.

Figure 13: PCFT versus UK banks to 31 May 2023

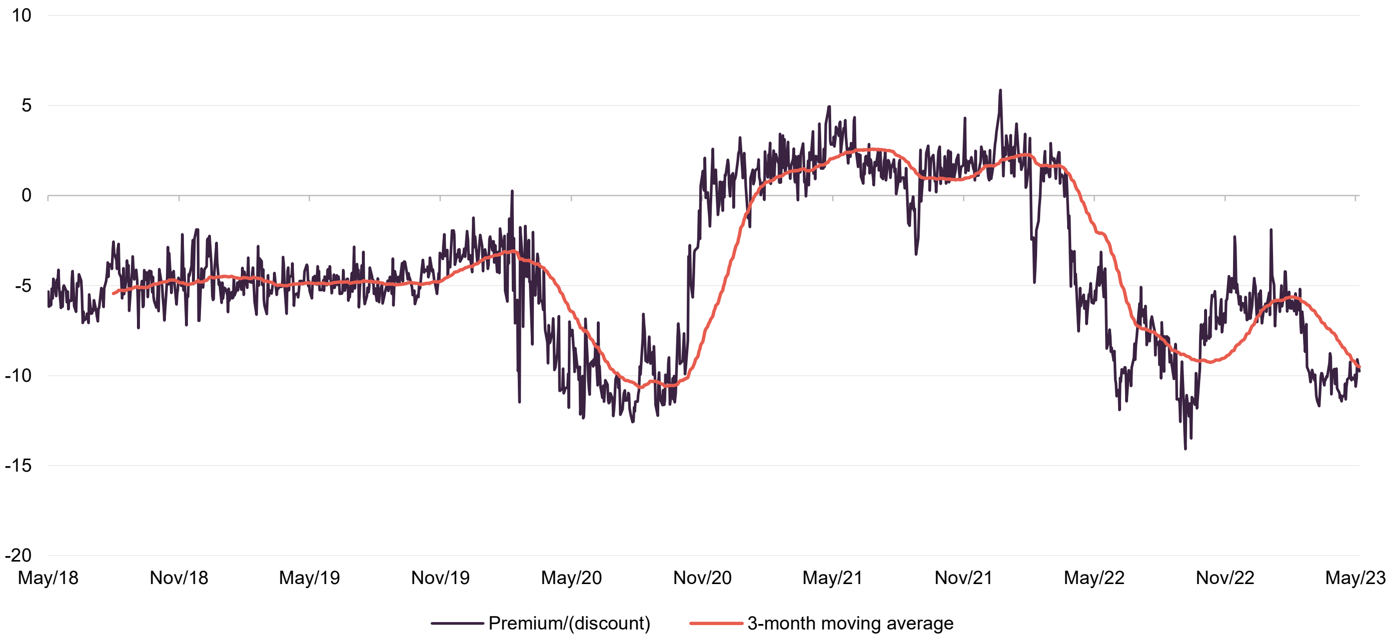
	One year (%)	Three years (%)	Five years (%)	Since launch (%)
PCFT price	(8.8)	50.2	16.7	79.6
PCFT NAV	(3.9)	60.7	22.9	102.2
Barclays	(11.6)	31.3	(23.3)	(42.4)
HSBC	11.7	59.6	(18.1)	(15.0)
Lloyds	(2.1)	47.9	(30.1)	(31.0)
NatWest	5.3	118.4	(12.4)	(14.5)
Standard Chartered	1.1	72.0	(16.0)	(54.7)

Source: Morningstar, Bloomberg

Premium/discount

Over the 12 months to the end of May 2023, PCFT's share price moved within a range of a 14.1% discount to a discount of 1.9% and has traded at an average discount of 8.0%. On 5 June 2023, the discount was 10.1%.

Figure 14: PCFT's premium/(discount) over the five years to 31 May 2023

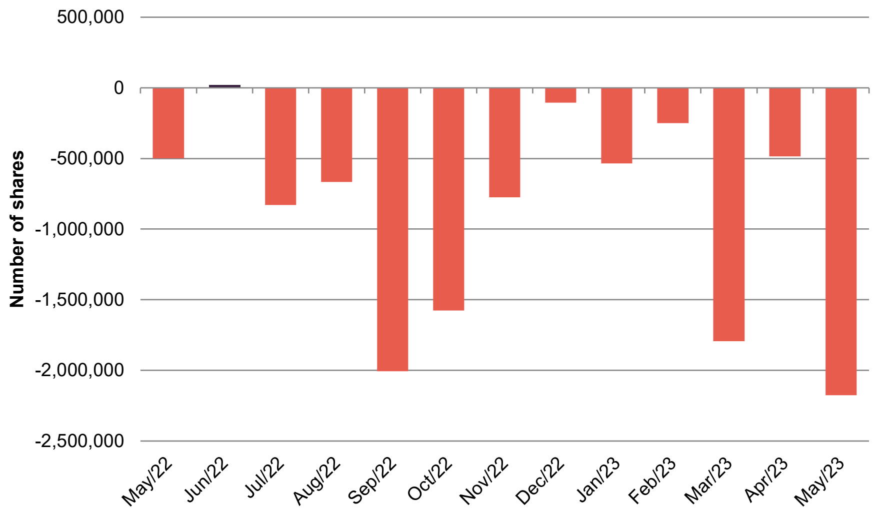


Source: Morningstar, Marten & Co

Looking at the long-term picture, the change in sentiment toward the financials sector following the vaccine news in November 2020 is evident in Figure 13. The shares traded at a modest premium to NAV for some time after that, but in April 2022, as investors became increasingly nervous about the health of the global economy, the shares moved to trade at a discount once again.

PCFT's discount has widened since the events described on pages 3 to 4 To be fair, discounts have widened across the investment companies sector. We feel that while further upsets cannot be ruled out in the short term, as nerves calm, PCFT's attractions should be recognised once more and the discount could narrow.

Figure 15: PCFT buybacks since 30 April 2022



Source: Polar Capital Global Financials Trust (data to close of business on 31 May 2023)

The board seeks to moderate fluctuations in the discount and premium through buybacks and issues of shares. On 1 February 2022, PCFT raised gross proceeds of £29.4m through the issue of 16,869,893 new ordinary shares at 174.31p per share, then a 1.5% premium to the NAV as at 31 January 2022. On 25 February 2022, PCFT raised gross proceeds of £16.6m through the issue of 9,905,427 new ordinary shares at 167.75p, again equivalent to a 1.5% premium to the prevailing NAV.

More recently, the board has stepped up and bought back stock, repurchasing over 11m shares net over the past 12 months.

Fund profile

PCFT looks to grow investors' income and their capital

More information on the trust is available on its website www.polarcapitalglobalfinancialstrust.com

Polar Capital Global Financials Trust (PCFT) has twin objectives of growing both investors' income and their capital. Its global mandate makes it a useful alternative for UK-based investors looking to diversify their financials exposure.

PCFT launched on 1 July 2013 with a fixed life. In April 2020, in conjunction with a vote on prolonging the life of the trust, shareholders were offered a cash exit. Holders of 39.1% of PCFT's then-issued share capital opted to sell their shares. The portfolio was reconstructed to facilitate this. Shareholders overwhelmingly approved an extension of the trust's life beyond May 2020 and the trust now has an unlimited life, but with five-yearly tender offers, the first of which is scheduled for 2025.

Predominantly, the portfolio is invested in listed/quoted securities. The trust may have some exposure to unlisted/unquoted securities, but this is not expected to exceed 10% of total assets at the time of investment.

Benchmarked against MSCI ACWI Financials

Since April 2020, the trust's performance benchmark has been the MSCI All-Countries World Financials Net Total Return Index in sterling (MSCI ACWI Financials). A history of earlier benchmarks is given in previous notes. We have used MSCI ACWI Financials for comparison purposes in this note.

PCFT's AIFM is Polar Capital LLP, which had AUM of £18.8bn at 30 September 2022 and employs 15 investment teams, spread across offices in Europe, the US and Asia.

PCFT's lead managers are Nick Brind, John Yakas and George Barrow.

Previous publications

QuotedData has published a number of notes on PCFT. You can read these by clicking the links in the table below or by visiting the QuotedData.com website.

Figure 16: QuotedData's previously published notes on PCFT

Don't fear a slowing economy	Initiation	30 April 2019
Banks too cheap to ignore	Update	29 October 2019
New lease of life	Update	22 February 2020
Too much pessimism?	Annual overview	22 October 2020
The tide has turned	Update	25 February 2021
More to go for	Annual overview	18 November 2021
Riding out the storm	Update	5 April 2022
Don't fear the dog that is yet to bark	Annual overview	30 November 2022

Source: Marten & Co

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