JANUS

August 2010

# Non U.S. Financials: Assessing the Issues

**Carmel Wellso**
Co-Portfolio Manager and Equity Research Analyst, Financials

At Janus, our goal is to deliver alpha by taking an unconstrained, in-depth approach to fundamental research. We extend this commitment to our clients and partners by providing access to the insights and opinions of Janus' seven global sector research teams via monthly analyst interviews. This edition of *Analyst Viewpoints* is the first in a two-part series examining the financial sector and features Janus' Carmel Wellso discussing the non-U.S. landscape with Client Portfolio Manager Adam Schor. Wellso offers insights on the challenges in Europe, as well as opportunities in Asia. Next month's edition will focus on the U.S. market and implications of its recently passed regulatory legislation.

***Q: Recently, there has been increased attention on the funding needs of European banks and governments. Why are these key issues for the markets?***

**Carmel Wellso:** In terms of funding, there are several concerns about bank liquidity portfolios and sovereign maturities coming due. Basically, no one is willing to lend to the banks based on worries these institutions won't be able to secure long-term funding and may soon face solvency issues. Consequently, bank maturities have continued to get shorter and shorter, and funding isn't as stable. There's limited demand for longer-term paper, which could be problematic if an immediate crisis arises that requires substantial fundraising.

The same concerns exist for sovereign entities. Spain offers a good example because it's the most immediate issue. Every week, Spain refinances approximately four to five billion euros in short-term paper, and these offerings have been generally well received in the marketplace. Demand for larger, medium-term maturities over one year has been more difficult to secure.

***Q: What are the solutions to this liquidity issue?***

**Carmel Wellso:** Confidence has to return to the system. One of the key concerns right now is whether these companies and countries are going to be able in five years to actually repay longer-term debt. Reestablishing investor confidence will most likely require a massive recapitalization of systemically weak banks, not the listed banks that are household names necessarily, but the small regional banks around Europe. These are the banks people are concerned about.

If these institutions are recapitalized and sovereign entities aren't required to fund them in the future, then confidence should increase in the systemic condition of the banking segment. Investors would then grow more comfortable lending on both an interbank and medium-term basis.

## Key Points

- European banks face fiscal and regulatory challenges, but there are selective buying opportunities.
- Asia continues to be resilient, without many of the handicaps seen in other markets.
- Fundamental research is critical given the level of macro uncertainty in the sector.

***Q: Do you think the "stress test" results just released in Europe may restore confidence?***

**Carmel Wellso:** Unfortunately, no. The stress test was based on a number of assumptions. In this particular case, similar to what we saw in the U.S., investors generally didn't think the underlying assumptions were difficult enough so we don't expect the findings to actually change much of anything.

***Q: So where will the funds to recapitalize these smaller regional banks come from?***

**Carmel Wellso:** We think the European Commission (EC) will have to step in with either a guarantee program, as in the case of Greece, or in conjunction with the International Monetary Fund (IMF) to provide sovereignties with enough cash to recapitalize their regional banking systems.

***Q: What about the fiscal challenges within the countries themselves? Are these primarily the result of bank exposure, or are there other fundamental budget concerns?***

**Carmel Wellso:** The two issues are closely linked. The good news is that very strong budgets have started to come out of some of these countries. The two that come quickly to mind are the U.K. and Spain, although both have taken different approaches to their fiscal issues.

The U.K. cut costs, raised taxes and focused on areas where the government could really "cut out the fat." By reducing spending, the U.K. doesn't require as much funding going forward, and the country's fiscal issues can start to be resolved. Spain went for more long-term structural reform. Given how strong unions are in that country, this approach is almost more important for long-term fiscal health. For example, 3% of Spain's GDP is paid in the form of unemployment insurance. That's a huge hit to the economy each year, and the government is trying to eradicate it.

***Q: How serious would it be if a country defaulted on its debt?***

**Carmel Wellso:** It depends on the country. If Spain were to default, it would be a very serious problem. The country represents more than 10% of the European Union's (EU) GDP and is a major trading partner for Germany, Italy and France. A default could start a domino effect where banks and insurers who own the country's debt also basically go under. The euro could also break up at that stage. As a result, the EC and other international players, such as China and the U.S., would likely do everything possible to prevent a default from happening.

A country such as Greece is a different situation. A default there wouldn't likely cause the same ripple effect. Greece is less than 2% of the EU's GDP and less linked into other countries' economies.

***Q: How has the European Central Bank (ECB) responded to these problems?***

**Carmel Wellso:** In terms of stimulus spending, the European Central Bank (ECB) has been slower to respond than countries such as China or the U.S. One of the reasons it's been less aggressive is because this is a group of countries with very different macroeconomic conditions and very different politics, which makes it difficult to reach a consensus group decision.

In addition, richer European sovereignties would likely have to bail out the poorer countries at this stage. This is a difficult political situation, particularly given the recent elections in many of these national governments and the pressure current leaders face in opinion polls. Most of these countries have a political structure with potential for a "no confidence" vote, where elections can be called if ratings drop. Once this occurs, the government can change fairly quickly.

In the U.S., there has been a great deal of concern about bailing out larger financial institutions and significant pressure on politicians who have allegedly saved the "fat cats" on Wall Street. The moral hazard argument in Europe could be even louder, especially given how many more political parties these countries have and how extreme they can be.

There certainly have been a lot of strikes in the region. While some have been more for show, such as in Spain, some have been more aggressive, such as in Greece. Unions are coming under greater pressure and losing power with many of these fiscal decisions, which will likely continue to fuel public outrage. And the impact of rising costs and lower wages due to austerity programs hasn't even hit yet. That's when public opinion may turn even more negative.

This is why the EU is going to resist taking strong action until a crisis forces its hand. It's simply not politically palatable, and each national government will have a strong battle in the press and the polls if it supports some sort of aggressive action, especially the transfer of wealth from richer countries to poorer countries.

***Q: Given these fiscal problems, what are your views on the euro?***

**Carmel Wellso:** We think the euro should continue to come under pressure as these issues unfold because of two challenges. First, these sovereignties need to raise more capital to fund the bailout of various banking systems. This will increase paper issuance, which will put pressure on the currency.

Second, the austerity measures and tighter budgets implemented by these countries will likely result in lower economic growth. Current consensus expectations for EU growth is around 1.3% per annum for the next three years. However, we believe it probably will be closer to 1%, possibly even below that once debt to GDP and the percentage of GDP that will go to interest payments are taken into account.

***Q: How will financial regulation changes affect these markets?***

**Carmel Wellso:** There are a number of factors that will likely lead to lower returns for these markets going forward. First, on the capitalization front, the Basel Committee of banking supervisors and central bankers has started to finalize Basel III regulations. These will revise the existing Basel Accords, which are guidelines on international capitalization and accounting standards.

Basel III is a hot topic on both sides of the Atlantic and in Asia. The reality is that the U.S. never really adopted Basel II, and while we think Europe will adopt Basel III, it will likely be watered down from its current form. We also expect it to be implemented differently country by country, based on each one's specific issues.

A second area that needs to be addressed is liquidity. Some European countries have already implemented liquidity changes. For example, the liquidity ratio put into place in the U.K. forces banks to keep more liquid securities on their balance sheets so they can meet any potential deposit outflows or other liability shortfalls. Obviously, holding short-term liquid assets as opposed to lending money will affect these institutions' profitability.

Another issue is provisioning.* These markets have had a sort of pro-cyclical provisioning policy, with many of these countries taking a "just-in-time" provisioning approach to bad debt. This has started to change, with increases in the coverage amounts required for any particular loan. As a result, banks are likely going to have to continue to provide for bad debt over an entire market cycle, as opposed to just when things start to get bad. While these costs should average out long term, investors probably won't see the peak in profitability these institutions had historically in good times.

The overall net result of all of these issues is lower profitability. This is expected to be compounded by lower leverage, which is also part of the new regime, and higher taxes. Several countries have actually implemented additional payroll taxes for the financial services industry and/or additional funding taxes for higher deposit insurance and fees. The bottom line is that there will likely be a lot of additional costs without additional revenue. Banks probably won't be able to pass all these additional costs to clients, and profitability will suffer.

***Q: It sounds like the sector has a difficult path ahead. Are there any investment opportunities given these challenges?***

**Carmel Wellso:** It's really on a stock-by-stock basis. These negative issues are already reflected in some companies' share prices, offering attractive valuations for firms with strong balance sheets and solid long-term growth prospects. Many are high-quality franchises with a large amount of earnings coming from outside the EU. Some also offer exposure to several long-term growth trends we are seeing in the financial sector. One example is emerging market insurance, which we think is a secular trend that won't be derailed by slower economic growth or regulatory changes.

Insurance in Asia offers very high wealth generation and high increases in GDP per capita. There is also strong growth and secular change in the insurance regulatory environment in those markets. Latin America is also very attractive to us, with low penetration in terms of banking and insurance products, both high-fee generation and high-margin businesses.

***Q: What other trends are taking place in Asia?***

**Carmel Wellso:** Asia continues to be resilient and doesn't face many of the handicaps seen in the European markets. Many of the liquidity requirements now being applied globally actually

* Reserves against capital as an allowance for bad loans.

originated in Asia after the last Asian financial crisis, and the region has already dealt with these issues. Standard Chartered is one example of a European bank with a strong Pan-Asian franchise. Because it has had to apply the stringent Asian capital and liquidity requirements historically, it has tended to have higher returns and much stronger capital levels.

From a credit perspective, Asian banks have been a bit more cautious lending outside the region, in many cases refusing to provide foreign banks with more than overnight funds. In their own markets, these banks continue to lend to borrowers with the best credit. This is consistent with a global trend of less credit being extended to marginal and smaller clients that don't have strong balance sheets.

Looking ahead, Asia offers much higher profit margins because it is a less competitive market, and these countries continue to have higher growth in credit formation due to higher GDP expansion. Consumer financing, a higher-margin business which historically hasn't been in the region, also continues to develop. Profitability in Asia may be slightly lower than it has been in the past due to higher global funding costs, but we still expect it to grow at a faster pace that is well above the averages in other markets.

***Q: Any examples of European banks taking advantage of the opportunities in Asia?***

**Carmel Wellso:** It really extends across emerging markets, not just Asia. We think these countries are going to be the primary growth engine for many banks over the next few years. For example, BBVA (Banco Bilbao Vizcaya Argentaria, S.A.) is a Spanish bank, but it also has the largest, most profitable banking network in Mexico, where return on equity is 40%, significantly higher than the current low-teen exposure in Spain.

An Asia-specific example is HSBC, which has a strong presence in the region. Asia has become a larger core portion of the company's earnings as countries in this region continue to see a stronger rebound relative to other markets. The strongest growth of the firm has been in private wealth management, as well as fixed income and equity issuance.

***Q: You mentioned insurance earlier. What are you seeing in this segment?***

**Carmel Wellso:** Life insurance is a particularly attractive area in Asia, primarily because it tends to follow the J-curve in terms of growth. As household income has increased in the region, the populations in these countries have continued to move from simply meeting their immediate living expenses to having disposable income. Asia has gone just beyond that initial starting point where people are beginning to spend on additional things, including putting more money into life insurance and other financial products.

This is the stage that tends to experience enormous acceleration in demand, particularly in savings vehicles, and Asia is no exception. In fact, premiums in life insurance are growing 20%-30% per year across Asia right now. Taiwan is probably the one exception. It is actually the most penetrated insurance market in the world. The high growth in China is mostly going to Chinese insurers because foreign insurance companies are not allowed by the Chinese government to expand aggressively. The growth in India is mostly through joint ventures with Indian firms.

Growth in Indonesia, Malaysia, the Philippines and Vietnam is also very strong. Singapore and Hong Kong are somewhat lower growth because these markets are more developed. Generally speaking, insurance companies in the more developed economies tend to provide higher cash flows, while firms in emerging markets are primarily focused on high growth.

***Q: How does Janus research these Asian companies?***

**Carmel Wellso:** Our analysts conduct extensive on-site research throughout Hong Kong, Singapore, Malaysia, Indonesia, China and India. We interview the companies we are evaluating, as well as competitors, and typically try to find people who have worked at the firms but may not be currently employed there. We also do various independent surveys to determine demand outside of what is published in broker and company reports.

Prudential offers a good case study for this process. When Prudential was thinking about buying AIA, the Asian operations of AIG, we did extensive research on the acquisition and spent a week in Asia meeting with employees of AIA, as well as employees who had left the company. We spoke to people who work for or had left Prudential. We spoke to the competition. And we did all this in Indonesia, Singapore, Hong Kong and China.

I personally met with specialists throughout the industry who were researching both firms' various product lines and margins to figure out if the acquisition was likely to happen, if it made sense and whether or not the company was pricing below market. We spoke with regulators to find out if there were going to be upcoming changes that could affect distribution in various countries, as well as accountants to determine if there were likely changes in any accounting assumptions or policies that might improve or hurt company earnings. At the same time, the Janus analyst who covers AIG here in the U.S. was conducting a similar exercise to get a sense of the parent company's views on its Asian business.

Even though Prudential did not make the acquisition, this research provided us with an extensive understanding of both companies. If and when AIA goes public, we now have very developed models on growth expectations, potential cost savings and productivity gains.

***Q: How important is this detailed level of research across the non-U.S. financial sector?***

**Carmel Wellso:** With so much macro uncertainty, it's critical. Our approach at Janus is to invest for the long term, and we have to be able to look beyond the short-term noise that can surround these markets in order to be effective stock pickers. That's why we focus on underlying fundamentals, while discounting for the macro impact of the various issues in these markets.

We conduct extensive scenario analysis, both at the company and country level, to help determine which opportunities are the most resilient, which have the strongest risk/reward characteristics and what types of challenges are likely to be encountered in the future.

One of the reasons Janus is so comfortable with these markets is that we know them extremely well. I was an Asian banks analyst for six years based in Hong Kong, and I've visited these companies many times. When I go back, I have a baseline to help assess what's happening in each specific branch. I also have contacts throughout the region that I've known for more than 10 years. This level of specialized expertise can be found across our research teams, and we think it gives us a collective, powerful edge in identifying stocks with the most compelling long-term potential.

**************************************************************************

**See last page for important disclosures.**

***About the Featured Analyst***

**Carmel Wellso**

Carmel Wellso is Co-Portfolio Manager and Executive Vice President of the Janus International Equity Portfolio and all related portfolios, a position she has held since June 2010. Ms. Wellso is also an equity research analyst, primarily focusing on the financial sector. Prior to joining Janus as a research analyst in June 2008, Ms. Wellso was a partner focusing on global financial services at Standard Pacific Capital. Prior to that, she served as Director of Asian Equity Sales for UBS Warburg. Ms. Wellso also served as an assistant director and Asian banking analyst with ING Barings Securities where she led the top ranked financials team in the Greenwich, Extel and Institutional Investor surveys several years in a row. She began her investment career as a credit analyst at MHT/ Chemical Bank (JP Morgan Chase) where she focused on Emerging Market sovereign exposures and financial sector lending. She received her bachelor of arts degree in English literature and business administration from Marquette University, her MBA from the Thunderbird School of Global Management and served for two years in the US Peace Corps in Kenya.  Ms. Wellso has 16 years of financial industry experience.



RC-0810(46)1210 EM PR