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Bank shares for gamblers

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Investors are well advised to steer clear of the shares of big banks. The investment risks are too high and their long-term performance is weak. This is unlikely to change in the future.

Less than a year after the disgraceful collapse of Credit Suisse, another internationally respected Swiss bank, Julius Bär, has made negative headlines. The people in charge took a gamble on the failed Austrian property mogul René Benko and extended presumably ill-advised loans to his opaque corporate construct.

Not surprisingly, the shattered confidence of investors led to the departure of Julius Bär's CEO. However, unlike Credit Suisse, there is a good chance that the resulting setback in the share price was temporary and that those responsible will learn their lessons.

From an investor's perspective, the question is whether bank stocks have any place in a securities portfolio. For decades, the industry has been under fire. Let's not forget that during the 2008 financial crisis, UBS had to be bailed out by the government because it had backed the wrong horse and invested in supposedly safe financial products in the subprime swamp.

Since then, the banking world has been plagued by numerous scandals. Examples include the money laundering and corruption cases involving FIFA, the Brazilian oil company Petrobras, the Malaysian state fund 1MDB, the Venezuelan state oil company PDVSA and the tuna saga in Mozambique. In addition, multi-billion dollar losses from risky deals with Archegos and Lex Greensill have seriously damaged the reputation of the banks involved.

That bank executives are nevertheless among the highest paid managers in the economy is at least questionable. Credit Suisse apparently employed more than a thousand so-called key risk takers who received salaries in the millions. This number is absurd, especially since the real risks are borne not by management but by shareholders.

Fallacies about salaries

Managers lack the will to exercise restraint. The oft-repeated argument that high salaries are necessary to attract the best talent is a fallacy that fails to convince even when it is constantly repeated. Banks need solid performers at the top, not superhumans. What is particularly disillusioning for shareholders of Europe's big banks is that, in the wake of all these scandals, "special factors" in accounting and toxic legacies have become the norm. Yet each generation of managers comes in promising to clean up their predecessors' messes and create a new culture. Improvements are promised, just to be quickly overtaken by the ghosts of the past. From the shareholder's point of view, two questions arise. Firstly: Does the bank's business model meet my qualitative requirements? If we take UBS, the last remaining Swiss big bank, as a benchmark, there is hope. The management team led by Colm Kelleher and Sergio Ermotti is determined to steer the bank towards a solid and promising future. But they and their successors will have to prove that they consistently put shareholders' interests first.

> "It lacks the willingness to exercise restraint among the responsible managers."

We will know more in five or ten years' time. In the meantime, UBS's reserve cushion, which currently stands at less than 5% tier 1 common equity, is far too thin to withstand any severe crisis without government support. Sergio Ermotti would also be wise to abandon his target of an 18% return on equity by 2028. High returns on far too little equity creates dangerous incentives, as history has shown.

Restraint is also called for in the dividend policy and share buybacks. UBS still has a long way to go to

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regain its former glory. Although the share price has risen significantly in the recent past, it is still almost two-thirds below its peak before the financial crisis.

Secondly, there is the question whether I, as a holder of bank shares, receive adequate compensation for my risk over the long term? A comparison of European bank equities with the overall market provides some insight. For example, in the period 2014 to 2023, the Stoxx Europe 600 Banks sub-index in Swiss francs generated a cumulative return of −0.7% (−0.1% p.a.), while the overall Stoxx Europe 600 generated a cumulative return of 51.8% (4.3% p.a.).

Over a longer period of twenty years, the situation for banks is even worse. The cumulative performance of bank equities was −32.2% (−1.9% p.a.), while the overall market returned 140.4% (4.5% p.a.). Investors' money seems to melt away like snow in the sun when it comes to bank equities. The situation is better for cantonal bank shares. Over the long term, many of the state banks' participation certificates have not only kept pace with the Swiss Performance Index (SPI), but have far outperformed the big banks. So if you want to grow your wealth with bank equities, you would be well advised to invest in cantonal banks rather than big banks.

But watch out for cantonal banks too

From a liberal and free-market perspective, it may be frustrating to realise that it's not the managers of the big private banks who look after the interests of their shareholders, but the representatives of majority state-owned cantonal banks. Beware: Anyone who believes that shares and participation certificates issued by the cantonal banks are essentially safe "widow-and-orphan investments" that allow you to sleep peacefully is mistaken.

The fact is that not so long ago several cantonal banks got into trouble due to mismanagement, and bad mortgages, had to be rescued with state funds or disappeared from the market. These include the cantonal banks of Appenzell Ausserrhoden, Berne, Geneva, Glarus, Solothurn and Vaud. Traditionally, these regionally active banks are heavily involved in the mortgage business, which is why their performance is in part dependent on the real estate market. Given that the last major real estate crisis in Switzerland was thirty years ago, it is difficult to estimate what shock waves a new crisis would trigger. But it is quite likely that it would also hit the cantonal banks' shareholders hard.

Not good enough

According to American professors Carmen Reinhart and Kenneth Rogoff ("This Time Is Different: Eight Centuries of Financial Folly"), there have been eight banking crises in Germany, fifteen in France, twelve in the UK and thirteen in the US since the beginning of the 19th century. In other words: On average, the banking world faces an existential crisis every twenty to twenty-five years.

Is there any reason to doubt that the future will be different? Not according to the facts. Anat Admati, professor of finance at Stanford University, once put it this way: "Today, every banker talks about what has improved. But better compared to very bad is not good enough".

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