

Bank Earnings in Focus: An Empirical Look at S&P 500 Banks

Large banks, including JPMorgan, Wells Fargo, Citigroup, and Bank of America, have reported first quarter results, and earnings and loan growth continues to be strong. However, share prices have pulled back, and investors may wonder which, if any, bank stocks still present value.

S&P Global Market Intelligence's recent paper, [*Banking on Alpha: Uncovering Investment Signals Using SNL Bank Data*](#), shows investors empirically which investment strategies¹ have been most predictive of bank stock returns historically. The paper identifies widely-used investment strategies that work well empirically, as well as lesser-used strategies that deserve investor attention. It also highlights the strategies that work best across varying macro environments: rising vs. falling interest rates and high vs. low financial stress.

Some key findings of the study for U.S. bank investors:

- Valuation was the strongest bank investment strategy, when tested empirically, followed by asset quality and profitability.
- Investors should favor two key valuation metrics: price to core earnings per share (EPS) and price to pre-provision net revenue (net interest income plus noninterest income minus noninterest expense), the two strongest valuation ratios historically.
- Improvement or deterioration in asset quality is senior to the absolute level of asset quality ratios. The 1-year change in the widely-used Texas ratio (non-performing assets plus loans 90+ days past due to equity plus reserves) was the strongest asset quality strategy historically.
- When examining profitability, it's just as important to consider expense *reduction* as it is to consider profit growth. The two strongest profit/expense ratios were the three-year changes in operating profit to Tier 1 common equity and total pretax expense to average assets.
- Low-cost funding was also a key performance-related characteristic historically: banks with a high percentage of savings and money market deposits outperformed, while banks with higher-cost funding (e.g., certificates of deposits) underperformed.
- Capital adequacy is most critical to bank performance when banks are under stress. During periods of above-average stress, as measured by the St. Louis Fed Financial Stress Index[®], banks with the highest capital adequacy ratios outperformed and poorly capitalized banks strongly underperformed. This stress index is currently well below average.

With the Federal Reserve in tightening mode, investors may also want to know what investment strategies have worked best in an environment of rising short-term interest rates. All investment strategies were tested across rising and falling federal funds rate regimes. In a falling rate environment, income-statement and balance-sheet ratios were much more important in determining bank stock performance than were valuation ratios. However, in a rising rate

¹ An investment strategy is a financial ratio that has been backtested historically to determine whether or not it has been predictive over the test period. Our backtest horizon was January 1990 through December 2016, dependent on data availability.

environment, the most effective strategies by far were those based on valuation and changes in asset quality.

How do S&P 500 banks stack up based on the strategies identified as key, historically, to bank share performance? Table 1 shows S&P 500 banks ranked in descending order, from best composite rank to worst, based on the six investment strategies discussed above. The composite ranking is an equal-weighted combination of all six investment metrics. A bank must have a value for at least five of the six metrics to be included.

Bank rankings on the composite model have changed over time. Several banks have risen over the past two years. For example, JPMorgan ranked 9 at the end of 2015, 7 at the end of 2016, and has since risen to 3. Citigroup has gone from 3 to 2 to 1, and Bank of New York Mellon has risen from 20 to 15 to 9.

Banks moving down in ranking over the past two years include Regions Financial, ranked 6 at the end of 2015, 17 at the end of 2016, and 17 currently; and Capital One Financial, which moved from 4 to 10 to 11.

Table 1. S&P 500 Bank Stocks – Investment Strategy Rankings and Composite Score: 1 = Highest Ranking / 21 = Lowest Ranking.

Company Name	Ticker	Market Cap (\$ Million)	Total Assets (\$ Million)	Core EPS / Price	Pre-Provision	Texas	Oper. Inc.	Pretax Cost	Savings & Money	Composite Rank
					Net Revenue	Ratio 1-Year Change	/ Tier 1 Comm. Eqty. 3Yr Chg	/ Avg Assets 3Yr Chg	Mkt. Deps. / Tot. Deps.	
CITIGROUP INC	C	162,417	1,821,635	2	2	5	12	8	N/A	1
CITIZENS FINANCIAL GROUP INC	CFG	17,276	149,520	15	12	3	1	1	7	2
JPMORGAN CHASE & CO	JPM	305,043	2,546,290	5	3	12	3	9	11	3
WELLS FARGO & CO	WFC	263,426	1,951,564	8	5	2	19	7	3	4
HUNTINGTON BANCSHARES	HBAN	14,074	99,714	9	10	1	6	11	10	5
BANK OF AMERICA CORP	BAC	228,372	2,247,701	16	8	4	9	5	N/A	6
SUNTRUST BANKS INC	STI	26,787	204,875	10	7	16	5	3	12	7
PNC FINANCIAL SVCS GROUP INC	PNC	57,429	370,944	14	14	8	13	4	2	8
BANK OF NEW YORK MELLON CORP	BK	48,727	333,469	6	17	9	4	14	N/A	9
FIFTH THIRD BANCORP	FITB	18,315	142,177	3	4	6	20	13	14	10
CAPITAL ONE FINANCIAL CORP	COF	40,065	357,033	1	1	19	18	21	1	11
BB&T CORP	BBT	34,888	219,276	7	6	15	16	10	9	12
PEOPLE'S UNITED FINL INC	PBCT	5,896	40,610	17	18	7	8	6	8	13
U S BANCORP	USB	85,576	445,964	12	11	10	17	12	6	14
M & T BANK CORP	MTB	23,635	123,223	18	16	13	21	2	5	15
KEYCORP	KEY	18,762	136,453	11	13	17	7	17	N/A	16
REGIONS FINANCIAL CORP	RF	16,862	124,545	13	9	18	11	19	13	17
NORTHERN TRUST CORP	NTRS	19,832	123,927	20	21	11	2	15	15	18
STATE STREET CORP	STT	29,952	242,698	4	20	14	14	18	16	19
ZIONS BANCORPORATION	ZION	8,133	63,239	19	15	21	15	16	4	20
COMERICA INC	CMA	11,801	72,976	21	19	20	10	20	N/A	21

Source: S&P Global Market Intelligence Quantamental Research, SNL Bank fundamental data. Data as of March 31, 2017. Past performance is not a guarantee of future results.

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