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Redefining Bank of America: an era of responsible growth

Take Note, February 2019
Hermes Global Equities

Bank of America has slashed costs and tightened risk controls in recent years as it moves on from its crisis-era legacies. In this case study, we examine the bank's conservative approach and our decade-long engagement with the company.

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Key points:

- We have a positive view of Bank of America, particularly on its profitability, growth and capital-structure characteristics
- In the past decade, Bank of America has adopted a conservative approach, cutting costs and tightening risk controls
- We have engaged with Bank of America since 2009 on its board composition and independence, pay, corporate culture and climate change. Our dialogue continues today.

Banks are safer on many counts than they were before the global financial crisis: there has been a sharp increase in capital requirements and what qualifies as a buffer against losses; regulations have constrained growth; some have been forced to simplify their legal structures; and funding is more stable.

Since the global financial crisis, Bank of America – the second-largest US bank – has repositioned itself as a sustainable business. It now focuses on driving responsible growth – a strategy that aims to keep a lid on costs and deliver slow and steady growth in every area of the company's operations.

In 2018, the bank posted a record net income of $28.1bn, and in February, it announced a rebrand of its investment units as it moves on from crisis-era legacies, such as regulatory probes and federal bailouts. The investment banking arm will now be branded Bank of America, rather than Bank of America Merrill Lynch[1].

Adopting a conservative approach

We have long held a position in Bank of America. Our proprietary Alpha Model views the company as positive according to its profitability, growth and capital-structure characteristics. The company looks particularly attractive on the longer term metrics that we use as well as three-month earnings revisions.

We see Bank of America as a strong brand, one which can use its size and diversity of offering to deliver growth, even in a difficult environment. In addition, it has consistently outperformed the S&P 500 financials index and the MSCI World financials index since 2013 (see figure 1).

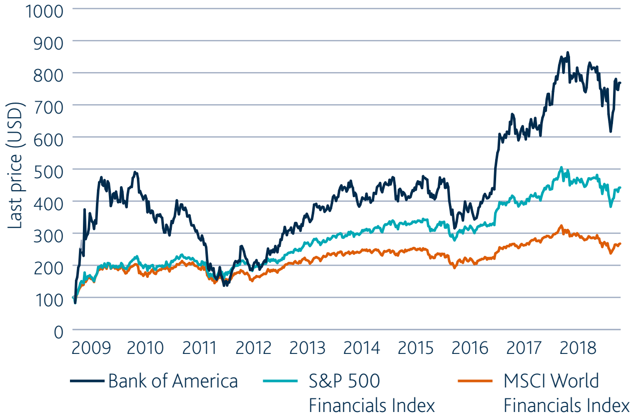
Recap: What is the Alpha Model?

The Alpha Model is our "automated analyst" which assesses the attractiveness of every investable company in our universe on a daily basis. The metrics used to select stocks are justified by both economic reasoning and statistical effectiveness, and have a long-term focus that leads to low portfolio turnover. They are grouped into six categories: valuation, corporate behaviour (including governance), growth, profitability, capital structure and sentiment. The model identifies which stocks have the most attractive combinations of these characteristics and the output is subsequently used to create an optimised portfolio that aims to maximise risk-adjusted returns. The Alpha Model also uses proprietary data from Hermes EOS to incorporate an assessment of corporate governance in every valuation (see The Alpha Model: laying the path to consistent returns). Together, these insights help us action compelling opportunities and pick long-term winners, like Bank of America, which prove beneficial to a diversified portfolio that aims to maximise risk-adjusted returns.

In January, the company posted solid Q4 2018 revenue growth – ahead of analysts' expectations – driven by its consumer bank. Under the helm of chief executive Brian Moynihan, Bank of America has adopted a conservative approach, cutting costs and tightening risk controls: in fact, over the last decade, the company has cut $30bn in annualised costs[2]. Its peer JPMorgan Chase missed profit estimates in Q4 2018, citing a decline in its fixed-income trading revenue, while Citigroup also posted a fall in bond trading.

[1] "Bank of America drops Merrill Lynch name from investment bank brand," published by Bloomberg on 25 February 2019.
[2] "BoA's loan growth drives better-than-expected profit," published by Reuters on 16 January 2019.

Figure 1. Bank of America has gained momentum in recent years



Source: Bloomberg as at February 2019.

A decade of ESG-focused engagement

We began engaging with Bank of America in April 2009 on a number of long-term ESG-related issues, ranging from risk management, governance and culture to remuneration. Initially, our ESG Dashboard flagged the company for its exposure to high-profile lawsuits, which related to the global financial crisis.

So far, our engagements with Bank of America, which span the last decade, have focused on:

- **Board composition:** In 2009, we urged the company to consider the board composition, particularly longstanding members and the need for refreshment.
- **Pay:** In 2010, we raised concerns about remuneration structures and the need to establish a policy that effectively aligns employees and the long-term shareholder interests.
- **Corporate culture:** In 2011, we pressed for greater alignment between risk-taking practices and the interests of long-term shareholders.
- **Climate change:** In 2016, we pressed for the company to increase its 2020 funding target for clean energy and other environmental activities. Last year, we asked the company to report against the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).
- **Board independence:** In 2017, we raised that we would like to see a good-quality candidate for its lead independent director. Separately, in 2018, we requested that the holding company discloses the names of the main bank subsidiary board's members and how they convene.

Driving progress on long-term ESG issues

Over the last decade, Bank of America has acknowledged our concerns and, in many cases, it has made great strides in tackling ESG-related risks.

The bank has made a number of changes to its board. During our engagements, we have discussed these changes as well as the appointment of directors with relevant expertise, such as risk management, financial and regulatory experience. In addition, Bank of America has transformed its culture, adopting a zero-tolerance approach to unethical conduct issues and questionable lending practices. In fact, its 2015 Corporate Social Responsibility Report highlighted how the company's purpose statement is driving its decision-making and strategy throughout the bank.

What's more, we were pleased that the company embraced our discussion on the living wage for its own staff. It has acknowledged our concerns about board independence and climate change. The bank has been examining implementation of TCFD reporting, forming an internal working group comprising of regional leads and internal risk and ESG committee team members. We expect to see a white-paper response to the TCFD recommendations this year.

Our dialogue continues today – and we await further improvements on long-term sustainability issues that we have raised in recent years.

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We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

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Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

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