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The Case for Community Banks in 2012

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The most difficult decisions for investors often involve overriding the emotional residue of past mistakes, and reconsidering the merits of a stock or industry with which one has had negative experiences. This was the case for many investors following the bursting of the technology bubble in the early part of the last decade, as they avoided or severely underweighted tech stocks, and ultimately missed out on the tremendous growth experienced by the sector over the last decade.

Today, it is the financials sector that causes the most visceral reaction for many investors, as they recall the bursting of the US real estate bubble and subsequent decimation of many banks and other financial institutions in late 2008-early 2009. More recently, regulatory pressures combined with macroeconomic concerns regarding the strength of the global economy have produced additional anxiety for investors.

However, as the US economic recovery continues to unfold, the time to consider investing in community banks may be upon us. In addition to compelling valuations, in our opinion, many of the fundamental drivers of community bank earnings have shown significant improvement, and signal potential opportunity ahead for investors willing to overcome emotional biases against the banking industry.

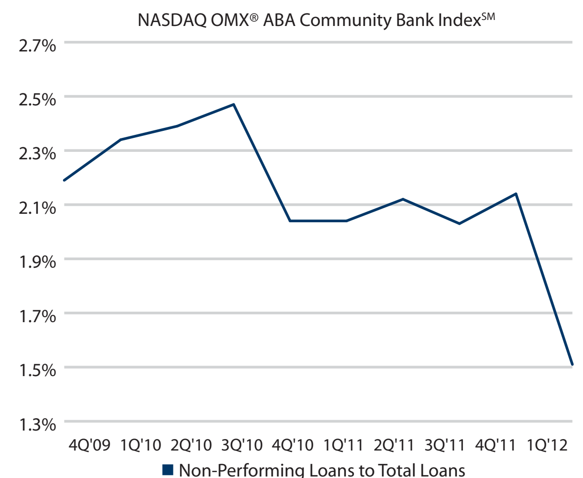
Net Interest Margins are Stable

Net interest margin (NIM), which measures the difference between interest paid to depositors and interest received from borrowers, divided by total interest-earning assets, is one of the most important drivers of community bank earnings. Since banks' borrowing costs are generally tied to short-term interest rates, and lending is generally tied to longer-term rates, the shape of the yield curve has a large impact on NIMs. While the positive slope of the yield curve has flattened somewhat over the past five quarters, smaller banks have had an advantage over larger banks when it comes to maintaining, and slightly expanding, net interest margins. For example, the average NIM for the NASDAQ OMX® ABA Community Bank Index℠ has trended slightly higher from 3.77% on 12/31/10 to 3.85% on 3/30/12, while the average NIM for the S&P 500 Financials Sector Index dropped from 3.04% on 12/31/10 to 2.66% on 03/30/12.[1] If the US economic recovery continues to gain a footing in the quarters ahead, NIMs may further expand as upward pressure is placed on longer-term interest rates, even as the Federal Reserve remains committed to maintaining a low interest rate policy until late 2014.

Credit Results are Improving

As the financial crisis unfolded in 2008-2009, substantial depreciation in home values plus a spike in the US unemployment rate exposed lax underwriting standards in the banking industry during the boom times. The resulting credit losses overwhelmed earnings and threatened the solvency of many banks. A dramatic tightening of lending standards followed, as banks sought to hoard capital and raise the overall credit quality of their loan portfolios. These efforts, combined with the gradual "rolling off" of bad loans, have resulted in a smaller proportion of non-performing loans to total loans for the NASDAQ OMX® ABA Community Bank Index℠, which declined from 2.5% on 9/30/10 to 1.5% on 3/30/12 (See Chart 1).[2]

Chart 1



Source: Bloomberg

These improvements have also eased the pressure on banks to increase their bad debt reserves, providing room for banks to deploy capital more productively. In fact, from 12/31/10 to 3/31/12, the average quarterly provision for loan loss to total loans for the NASDAQ OMX® ABA Community Bank Index℠ decreased from 0.31% to 0.14%.[3]

Encouraging Loan Growth Trends

A resurgence in demand for new loans from both businesses and consumers, combined with credit standards that are beginning to relax, points to potential loan growth for US banks in the months ahead. According to the most recent Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices (released on April 30, 2012), the net percentage of domestic banks reporting stronger demand for Commercial & Industrial loans increased in April for loans to both large and small borrowers, continuing a trend that began early last year (See Chart 2, on Page 2).

Additionally, the net percentage of respondents reporting stronger demand for commercial real estate loans increased to 39.7%, the highest level since 1998.

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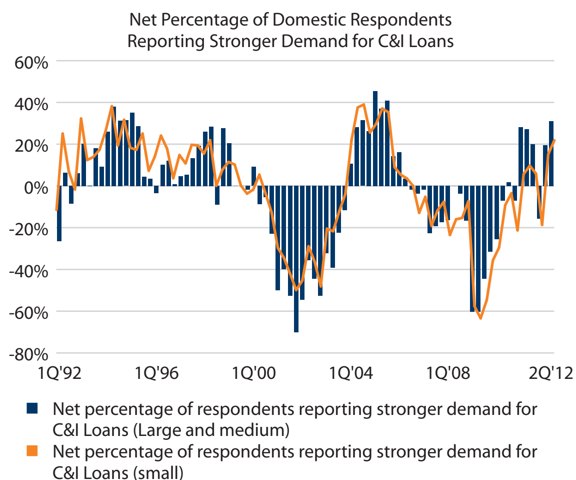
Past performance is not a guarantee of future results and there is no assurance that the above mentioned events or improvements will continue.

Chart 2



Source: Bloomberg

Demand from consumers has picked up as well, as reflected in the net percentage of banks reporting increased demand for auto loans (35.3%), credit card loans (17.5%), and other consumer loans (16.4%), each of which reported a strong increase in the April survey referenced above. A gradually improving employment picture may provide an additional tailwind for the level of consumer borrowing in the months ahead.

Why Community Banks?

One important feature of most community banks versus larger financial institutions is their inherent concentration on domestic/local area banking, versus international banking. As a result, the performance of community banks tends to be more sensitive to the domestic economy, and may be less impacted by international affairs, such as the current economic and political turmoil in Europe.

Another emerging trend that undergirds the investment thesis for smaller banks is the recent surge in mergers & acquisitions in the US banking industry. While the second half of 2011 was relatively light on M&A activity, the first quarter of 2012 brought a sharp increase among US banks, as year-over-year M&A deal volume increased by 20.4%, and the average premium at which deals were announced was 79.4%.[4] While increased regulatory pressure and size limitations may prevent some of the largest banks from seeking new M&A deals, strong incentives remain for the next tier of regional banks to seek acquisitions of smaller community banks in order to tap into an existing base of customers and deposits.

As the US economy and the banking industry continue to recover, we believe it may be time for investors to consider the long-term opportunity offered by the First Trust NASDAQ® ABA Community Bank Index Fund (QABA). This ETF provides diversification for investors with over 100 community banks from across the nation, thereby providing geographical diversification that is lacking in many individual community banks. If positive trends regarding net interest margin expansion, improvements to credit quality, and increased loan growth continue to materialize, we believe community banks are well positioned for growth in the years ahead.

[1,2,3,4]Bloomberg.

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RISKS

The fund's shares will change in value, and you could lose money by investing in the fund. One of the principal risks of investing in the fund is market risk. Market risk is the risk that a particular stock owned by the fund, fund shares or stocks in general may fall in value.

The fund's return may not match the return of the NASDAQ OMX® ABA Community Bank Index℠. The fund may not be fully invested at times. Securities held by the fund will generally not be bought or sold in response to market fluctuations. The fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

This fund is concentrated in the securities of NASDAQ® listed community banks as defined by the index which involves additional risks, including limited diversification. These companies are subject to certain risks, including the adverse effects of volatile interest rates, economic recession, increased competition from new entrants in the field, and potential increased regulation. The financial performance of these companies may also be highly dependent upon the business environment in certain geographic regions of the U.S. and may be adversely impacted by any downturn or unfavorable economic or employment developments in their local markets and the U.S. as a whole. These companies may also be subject to interest rate risks and changes in monetary policy as their earnings are largely dependent upon their net interest income and lending risks that could further increase because of increases in interest rates and/or continuing economic weakness.

The fund is classified as "non-diversified." A non-diversified fund generally may invest a larger percentage of its assets in the securities of a smaller number of issuers. As a result, the fund may be more susceptible to the risks associated with these particular companies, or to a single economic, political or regulatory occurrence affecting these companies.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.

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