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Despite Negative Headlines, Are Bank ETFs a Good Call?

With Deutsche Bank and Wells Fargo making news for all the wrong reasons, are bank ETFs still a solid bet?

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Lost in our focus on trying to predict when the Federal Reserve will approve a rate hike is the actual impact a rate increase will have on banks.

Analysts already are lining up to sing the praises of bank stocks and funds, even after negative news coming out of the sector on Well Fargo's (**WFC**) recent "ghost" fee scandal and on massive layoffs at Deutsche Bank (**DB**) , where 10,000 staffers are estimated to be on the chopping block.

Yet a slew of major bank stocks, including Bank of America (**BAC**) and Wells Fargo, beat analyst expectations in recently-released third quarter earnings, and anticipation over higher interest rates seemed to be a major driver of that quarterly outperformance. As a result, bank ETFs are significantly outperforming other key equity market benchmarks.

"The Fed, however, is looking like it's finally getting ready to move, and that's been a good thing for bank stocks," states David Dierking, an analyst with ETF Daily, in a research post last week. "Since the Brexit vote low on June 27, the SPDR S&P Bank ETF (**KBE**) has returned nearly 22%, largely on the prospect of higher rates on the way. During the same time, the S&P 500 has returned 7%."

In the "past is prologue" category, that's not to say the banking sector doesn't have some significant headwinds going forward.

"The banking sector has struggled through the great recession and since, being the second lowest performing sector in the S&P 500 year-to-date," says Jerry Braakman, chief investment officer at First American Trust, based in Santa Ana, Calif.

Due to the lack of participation in this bull market, bank sector valuations are attractive in comparison to the run up in valuations in other segments of the market, Braakman adds. "At the same time, banks continue to be faced with significant challenges in their business from a regulatory perspective, which both Deutsche and Wells Fargo exemplify."

Braakman says his firm sees banks outperforming in rising rate scenarios, as net interest margin expansion provides an improving earnings profile. "With the odds of another rate hike around the corner, it may be timely to purchase into the sector via an ETF," he says. "Considering lackluster global growth prospects, and weak economic statistics in the domestic economy, we believe it is still uncertain as to whether the Fed will raise rates in December. Hence, building a position in bank stocks would be best accomplished by averaging in over time."

Bank ETF buyers need to be wary, however. "Banks are really a mixed bag right now," Braakman offers. "On one hand most large European banks like Deutsche Bank and Credit Suisse (**CS**) are trading near all-time lows with a huge host of problems. And while major U.S. banks appear to be in a better financial position than their European counterparts, there's really no telling how a solvency issue in Europe might impact them given their intertwined derivative exposures."

Braakman suggests avoiding both groups and focusing instead on small regional and community banks in the U.S. "Many of these are very cheap, have good dividend yields, and could benefit from higher interest rates," he explains. "Moreover, given the well-documented constraints facing small banks due to the Dodd-Frank Wall Street Reform and Consumer Protection Act, many of these banks could be takeover targets as the industry continues consolidating."

"And if we see reforms to Dodd-Frank - an idea that's popular on both side of the aisle - the reduced regulatory burden on small banks could boost their earnings considerably," he adds.

Investors can opt for a fund like the SPDR S&P Regional Banking ETF (**KRE**) or the First Trust NASDAQ ABA Community Bank ETF (**QABA**) , both of which provide broad-based exposure to smaller banks, Braakman advises.

Other money managers concur with that bullish assessment on banks, noting that while challenges do exist, the upside is worth the risk.

"We are positive on the banking business," says Christopher Marinac, co-founder and research director at FIG Partners LLC, in Atlanta.

Marinac pegs three primary reasons for his firm's positive outlook on banks:

(1) Profitably is solid, and the underlying loan and deposit balances continue to grow.

(2) Credit costs remain low, as the degree of problem assets in the industry is small.

(3) Expense growth (i.e., core overhead) should be low and trail the pace of revenue increases over the next year. "Banks are taking out costs by reducing branches, and overhauling how they process transactions internally," he says. "We think lower costs are still a tailwind for the banking industry."

"There are some challenges from ongoing pressures of low interest rates, such as lower net interest margins, and regulatory oversight, such as Dodd-Frank rules implementation," Marinac adds. "But, these are no worse today than in past months and largely embedded in the current earnings base."

Other Wall Street analysts advise investors new to the banking sector to stick to ETF's with a diversified exposure to the financial sector. Recently, Zacks Research issued high marks to three ETFs: PowerShares KBW Bank ETF (**KBWB**) , iShares U.S. Financial Services ETF (**IYG**) , and Financial Select Sector SPDR ETF (**XLF**) **. "**Overall, the banks look good and so does the financial sector at large," the firm states.

For banks, it's been a wild ride over the past decade. Right now, though, financial stocks and funds seem to be flowing more calmly, and in the right direction for profit-minded ETF investors.