New Hope for Financial Stocks

Rising Interest Rates Give Investors Reason to Return to Sector

Five years after the darkest days of the 2008 crisis, investors are tiptoeing back into financial stocks, lured by the promise that rising interest rates will revitalize pinched profit margins at banks and insurers.

Since U.S. Treasury rates began climbing in May, the KBW bank and insurance indexes have outpaced the S&P 500-stock index, a turnaround for sectors that have lagged behind the broader market since the failure of Lehman Brothers Holdings Inc.

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Propelling the shift is a wager that the Federal Reserve will begin paring back its extraordinary stimulus for the U.S. economy as soon as this week, a move that many investors expect to result in higher long-term interest rates. Lawrence Summers, a candidate to be the next Fed chairman until Sunday afternoon, when he withdrew his name from consideration, was considered more likely to act soon to pull back stimulus. But most market participants expect rates to move higher over the long term.

Higher rates boost the spread between what banks pay for deposits and what they earn in lending. Increases in long-term rates enable insurers to set aside less money for future claims.

Some investors say the rate trend is good for the broader market as well. Financial companies’ lending and investing spur job creation and healthy risk taking.
Many fund managers are betting on life insurers such as MetLife Inc. MET -0.91% and Prudential Financial Inc., PRU -0.33% both of which are up more than 40% this year.

Others are wagering that beaten-down banks and securities firms will stage a rebound as economic growth improves, providing greater opportunities to reap profits by lending, trading and managing investor accounts.

"Banks and insurance companies are much healthier today than they were during the financial crisis," said Steve Kaszynski, a portfolio manager at Eaton Vance's EV +0.66% $7 billion Large-Cap Value Fund. His fund has been buying MetLife along with Morgan Stanley, MS +0.39% the New York financial firm whose shares are up 47% in the year to date, and SunTrust Banks Inc., STI +0.27% the Atlanta lender that has advanced 18% in that time.

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The inflows follow a period in which investors fled the sector. Despite their gains this year, the KBW Insurance Index still lags the S&P 500 over the past five years and the KBW Bank Index of large commercial lenders remains about 20% below its September 2008 level. The S&P 500, by contrast, has risen 34.5% over the last five years.

The rate of return on life insurers' investment portfolios fell to less than 5% last year from 6% in 2007, said Matt Carroll, analytical manager for North American life insurance ratings at the Standard & Poor's unit of McGraw Hill Financial Inc. MHFI -0.47% Insurers often invest premiums in long-dated bonds to pay for future claims, a practice that makes their profits especially sensitive to rate trends.

Andrew Sleeman, a portfolio manager at Franklin Templeton Investments' Mutual Financial Services Fund, said he bought MetLife more than a year ago, citing its strong management and scale. He also holds stakes in Norwegian insurer Storebrand STB.OS +0.65% ASA and Resolution Ltd., RSLLF +4.90% a U.K.-based insurer.

"In all of these cases, we bought them at a time when a scenario of low long-term interest rates forever was priced into all these stocks," said Mr. Sleeman, whose $409 million fund invests at least 80% of its assets in financial-services companies.

Higher rates also stand to boost banks' bottom lines. Net interest margin—a measure of the spread banks capture in borrowing at short-term rates and lending out for longer stretches—hit 3.54% in the first quarter, the lowest level since at least 2000, according to data tracker SNL Financial. In the second quarter, the figure rose to 3.58%.
To be sure, higher rates aren't completely good. Scott Armiger, chief investment officer at Christiana Trust, which oversees $5.6 billion in assets for individuals and institutions, points to a slowdown in the mortgage market. Mortgage applications fell 13.5% in the week ended Sept. 6 from the previous week, the Mortgage Bankers Association said last week.

Mr. Armiger also worries about legal and regulatory battles ahead for large financial companies, along with soft U.S. growth. He owns shares of J.P. Morgan Chase JPM +0.67% & Co., the nation's largest bank by assets, and Wells Fargo WFC -0.17% & Co., the top U.S. home lender. But he said J.P. Morgan's legal troubles and Wells Fargo's exposure to the mortgage market make him leery of taking bigger positions.

Amid a regulatory crackdown on its practices in businesses ranging from derivatives trading to electric power, J.P. Morgan will spend an additional $4 billion this year on risk and compliance, said people familiar with the matter, adding to a legal tab that totaled $17.7 billion from 2008 to 2012.

Mr. Armiger says he favors insurance companies Aflac Inc. AFL +0.28% and Genworth Financial Inc., GNW -0.81% and will continue to hold a relatively low concentration of financial stocks until economic growth picks up.

Still, fans including Mr. Kaszynski of Eaton Vance, view the sector as cheap and say investors should keep an eye out for companies whose shares have been overlooked.

"Low interest rates over the past couple of years have cut into interest margins," said Burns McKinney, a portfolio manager at the $8.8 billion AllianzGI NFJ Dividend Value Retail fund. "As those longer-term rates go up, [financial companies] benefit."

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