



## Holland Views: US banking sector

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# US banking bulls...And in good company

Attached and below are the thoughts of ourselves and of those that are far smarter than us, on the US economy and in particular the US banking sector. You may or may not want to read what a non specialist investor the wrong side of a large ocean thinks about such a sector (us), if you do see below. We do however strongly recommend you pay closer attention to both Jamie Dimon and Bruce Berkowitz. Extracts from Jamie Dimon's recent shareholder letter are in the appendix as is a link to the full letter – It is a great (and surprisingly bullish) summary of where the market, banks and the US economy sits today. Also attached are older comments and links to Bruce Berkowitz's assessment of Bank America (he is a top 10 shareholder). His US financial sector expertise and obsession with it attracts us to him as does the reading we have done of his strikingly similar call in Wells Fargo during the of the 1990-1 recovery. His only real crime this time is...he was too early.

[Jamie Dimon's 2011 Shareholders Letter –](#)

[http://files.shareholder.com/downloads/ONE/1826141624x0x556144/cafb598e-ee88-43ee-a7d3-70673d5791a1/JPMC\\_2011\\_annual\\_report\\_letter.pdf](http://files.shareholder.com/downloads/ONE/1826141624x0x556144/cafb598e-ee88-43ee-a7d3-70673d5791a1/JPMC_2011_annual_report_letter.pdf)

[Bruce Berkowitz BofA Analysis Aug 2011 –](#)

<http://www.fairholmfunds.com/pdf/BACtranscript04102012.pdf>

[Bruce Berkowitz interview –](#)

<http://blip.tv/wealthtrack-portable/bruce-berkowitz-5561111>

## The Layman's View

Last year we sent a number of thoughts out where we suggested that we are bullish on America, its consumer, its banks and even its house prices. This was not the result of detailed modelling of each and every company but a wider assessment of a variety of economic and sentiment indicators. Today we re-iterate the view that the best consumer/housing/banking markets to invest in worldwide are those that have:

- Suffered the most significant losses, thus truly purging any built up longer term excesses
- Whose consumer behaviour in savings rates and unemployment have reflected these collapses and had time to do so
- Where the asset prices that caused widespread losses have then stabilised – US housing and commercial property
- Where affected banks have been recapitalised a number of times as a result to the point of overcapitalisation and where provisioning for losses has been addressed many times
- Where the structure of society, commerce and regulation is still highly capitalist and free market in nature
- Where many of the asset classes that could benefit from normalisation or recovery are still heavily disliked or mistrusted by most public or private investors

We continue to believe that this checklist gives you a short list of two geographies to be more bullish on than others, the US and Ireland. If we were then to add an attraction to sectors in which investors are maybe wrongly extrapolating recent negative momentum and trends this give us even greater reason to look at US banks more closely.

### Things have moved on

Clearly since Christmas sentiment and share prices have improved somewhat for the US banks sector (rightly in our view). So for those that insist on only buying at the very bottom the moment may have passed. However, despite the rally, the US financial sector still looks to us to offer great value for the quality of franchises available. Clearer evidence of improvements in employment, housing and loan defaults are now visible suggesting that if investors are getting the lowest possible entry price they might also not be getting the maximum risk.

## What can we possibly add?

Many analysts cover this sector in enormous depth, but such detailed knowledge did not help many from seeing the wood from the trees when it mattered pre summer 2007. We have no doubt there exists some very bullish analysts that likely understand all the arguments we highlight here and also have the detailed knowledge to back it up. But we also observe:

- A \$100bn Market cap share we think could be very cheap, only receives a buy recommendation from 25% of those that cover it, despite having 50% upside in the share just to reach tangible book value (BofA)
- As Jamie Dimon observes, he has met many investors recently who have said, “*Bank stocks are uninvestible.*” We wonder how many thought that 5 years ago?
- Few of the banking shares whose valuations have recovered from their lows take any account of future earnings power or the fact that balance sheets are loaded with provisions for both future loan defaults and litigation

In short we are bullish on most of the companies we have looked at. These include **JP Morgan, Bank of New York Mellon, Goldman** (*you don't go to jail just for thinking it you know*) and **Bank of America**. Each has their own specific points or risk/ reward/ valuation attractions. We could spend another month or two on just one of these companies and still not know everything but we observe that there are very few sectors where nearly all of the big stocks you look at you think could be undervalued. Thus we accept on each of these companies you will be able to catch us out if you so choose by asking us an obscure question about an obscure division.

### Mr. Market is just not that smart

We realise this is a dangerous assertion as often Mr. Market seems to have an almost mystic power to predict the odd profit warning but this statement has been true for a hundred years and despite all our clever technology it will likely be so for another 100. I was lucky enough to read the right things (Thank you Messrs Shiller + Grant) in 2005-7 and as a result could only conclude to be negative on US housing, consumption and credit. Like many of us I rue my lack of conviction that may have enabled me to profit far more at the time. What stopped me doing so? Respect for Mr. Market. I can remember thinking around that time: ‘*Can I really have worked this out just from having read a few widely known about publications and applying the limit of my education (a maths ‘o’ level)*’. Many other people believed or forecast the events that followed far better than I, but I try not to forget the false respect I had for Mr. Market at that time.

Attached or linked to this email are various extracts from either JP Morgan or Bank of America that we want you to take a look at. One is the Bank of America 5 year financial track record. Much of the information is irrelevant as its recent past and likely future will be quite different. Worth noticing however, is the 2007 column, for this shows the tangible book value of BofA was then \$12.71, almost the same as that reported at the end of 2011 (\$12.95) and 2010(\$12.98) albeit that these were the net figures of some very large offsets. Interestingly we can also see the range of share prices paid for that tangible book value during 2007; between \$41-\$54. Today we can all look at our screens to see that the same quantum of book value is now priced by Mr. Market at only \$8.23, quite a contrast.

In short, thousands and thousands of people were wrong in 2007 about this and so many other shares because they were following the herd of market sentiment and extrapolating recent company reported trends. Too few did enough thinking for themselves.

#### [Follow or listen to the smart money](#)

Bruce Berkowitz's motto is "*ignore the crowd*" and Buffett famously hides himself away much of the time. Both however are pretty bullish on the US economy, a US Housing recovery, a banking normalisation and Bank of America's stock.

To follow up on these thoughts call some sector analysts if you want but be aware they might just be infecting your brain, building in the doubt that stops you having the conviction maybe you should have - a lot like 2007...? Alternately do what these two do and we have tried to do in recent weeks and read the company information yourself. It is surprising what you find and the confidence (or not) it gives you.

#### [How to get sued if you are an accountant or auditor](#)

All investors rightly worry about the bad debt losses and mark to market problems that such huge balance sheets can possess. We do too, but we worry about them a lot less 4 years in to a downturn after the list of factors we gave on page one have occurred, than we do before one. We also observe that others have jobs to do and all professions have their biases. In short whilst we assert that investors should do their own homework we note that the accountants and auditors have now had a long, long time to assess the true realisable value of assets and loans. When asset values are collapsing it is hard for them to be criticised or to get ahead of the provisioning curve as some early value investors attracted to the banking sector will tell you. Like markets, accountants and auditors however extrapolate recent concerns in their provisioning (note the Irish Stress test scenario and how much more bearish it was than other countries). Most bank auditors and accountants made huge mistake 5 years ago but the surest way for them to get fired in 2012 we suggest is to be caught under-providing for a liability. Maybe, just maybe today's US bank balance sheets are what they are supposed to be, prudent real assessments of actual assets and liabilities, not the rose-tinted ones they were?

#### [Compounding - Misunderstood the world over](#)

We have long bored on that markets don't really understand compounding and that is why sometimes a few cheap high returning business can be bought at attractive prices. Today BofA can be purchased with upside to its tangible book value of 57%. However were the group to grow that tangible book by just 12% p.a. in the next 2 years, its tangible book value would rise to \$16.2, thus making the upside to it 100%. It is the combination of factors listed earlier and the effects of this compounding that we suggest some investors may be failing to accurately consider. The discount to a prudent starting value only increases as earnings power comes into play.

## Stock Views

We had planned to write a short comment on each company mentioned earlier but feel we have maybe made the points we can to try and give you the perspective we see and how we would approach the detailed analysis needed on each company. Instead we make a couple of brief comments on a few of them and give a sector analogy.

### Goldmans – “But it is not the franchise it once was”

Maybe this statement is true, but we think it is safe to say the same thing about Lehman’s, Bear Sterns or my old employer Merrill Lynch! To quote an old adage: ‘*to finish first you must first finish*’. At the big discount to tangible book these shares sat on earlier this year, they were attractive to us as we only had to believe 2 things:

1. That the people running it might not be as completely stupid as the share price might indicate.
2. That when they say they are ‘*fanatical*’ about mark to market they are not lying.

The revulsion our January thoughts met with were telling just by themselves.

### Bank of America

For those that want to consider BofA more closely take a look at page 7 of the year end financial press release. In 2011 it managed to make a further loss of \$19.5bn in a division (Consumer Real Estate) that only has an average loan balance remaining in of \$112bn. This was due to further provisioning and providing for possible mortgage litigation. Clearly while such events and costs can never be certain to now cease they are highly unlikely to continue for much longer at that scale. The group’s other divisions meanwhile make returns on equity that are good or perfectly acceptable and the strategy remains to “*build a fortress balance sheet*” and “*deliver on the shareholder return model.*” Arguably they are doing both. It is by stripping out such one off items mentioned above that it is easy to see BofA’s significant underlying earnings power. Berkowitz estimates this at no less than \$4 a share. Our calculation earlier of only a 12% ROE results in book value rising from \$13 to \$16 in only 2 years. Now as an example of the clarity you can find in the accounts take a trip to page 102 of the 10K, there you will find a level of disclosure of the group’s southern European exposure that would put most European banks to shame. A share that we consider could be highly mispriced.

### JP Morgan

Just read Mr. Dimon’s letter for a good lesson in operational management and capital allocation. There is even a section (page 37) entitled ‘Why would you want to own our stock?’

## High uncertainty not high risk

Many of these companies have many uncertainties from legacy assets, to Southern European exposure, regulation or political hatred... the list is long. Key however, is that the biggest assets they are/were exposed to are either already depressed and have thus reported the bulk of the losses likely (US Housing) or are making sub normal/optimal returns currently (investment banking). Regulation and capital requirements are uncertainties that remain but arguably these just make the sector uncertain not necessarily risky as risk is partly a function of the price you pay.

## An analogy ( but not a very good one!)

Five years ago in your local high street there were 6 sandwich shops all of which had been competing with each other for years with new stores opening all the time. The last 2 of the 6 to open were low cost sandwich producers who undercut existing shops who in turn cut costs themselves to keep up. Competition drove more choice for the customer and also drove down the price of sandwiches. No consumer complained.

Then suddenly four years ago 2 people got food poisoning from one of the shops and it was all over the local paper. The council got involved and shut the shop down straight away. It also then regulated the whole sandwich shop industry in the town and inspectors were appointed. Before their report was published (which took 12 months to complete) another shop closed because there was almost no business to be had and they were worried what the inspectors conclusion might be. Finally, the report came out. It said that the health standards in some of the shops had been appalling with poor facilities and poorly trained staff. New rules were brought in that were expensive for the shop owners to comply with and also made it very hard to open a new shop unless a special licence was granted by the council. As a consequence the two low cost shops closed down as well. The town was then left with only two sandwich outlets. Today these two shops are still open, they do a reasonable trade and are able to pass on the increased cost of regulation and health and safety to customers that are a) captive and b) realise they have to pay a decent price for a decent product. No consumer is complaining even though sandwiches cost a little more.

The consolidation of all parts for the banking industry has been colossal as has the regulatory backlash. There are drawbacks of such regulation but there may yet be benefits too. Economies need a properly functioning banking sector and even the strictest regulators realise this fact. They also need functioning capital markets. Exactly what profits each sub-sector or company makes in the future is hard to forecast but that surviving trusted financial brands make some sensible returns seem far, far more likely than not we conclude.

## Conclusion

We are not unaware of the risks global financial sectors face with EU area uncertainty, but we have a job to do – To find and invest capital in the best global franchises that will prove more resilient and have greater future earnings power than Mr. Market currently believes. On that measure alone many US financial share look very appealing.

Do look at Jamie Dimon's letter.

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