



Holland Views – US Banks

US banking bargains in plain sight

We have written a few times this year on the global sector that we consider most mispriced – US banks. In light of a number of recent results and news we wish to strongly reiterate this view, encourage you to reconsider our earlier work on the sector and recommend some new instruments that we think could be a great way to play the sector over the coming years.

Those of you that have read ‘The Big Short’ by Michael Lewis will know the name Mike Burry. For those who have not, he was a loner fund manager who called the subprime crisis very very early having built a great stock picking reputation before doing so. In his Q1 2008 investment letter he wrote the following:

‘Recently the stocks of financial companies announcing additional write-downs have shown resiliency, often rising on the news. To many this reflects a bottoming of sentiment in the sector as investors look forward. However, one must recall that share prices reacted similarly in each of the last two quarters in which substantial, sometimes shocking, write-downs were announced. This perhaps reflects investors’ memory of the terrific returns provided by these companies not so long ago, as well as their greed and the fear of missing a bottom. (our underlining)

Yet it is worth considering what these companies look like when we look forward. Great difficulty accompanies any effort to value financial institutions today because share counts are in the midst of repeated dilutions due to emergency capital injections. With final share counts truly unknown and capital adequacy still not fully addressed, a conservative approach to establishing even a market valuation is problematic...

...Any investment thesis in these companies must therefore be based upon modest returns on a substantially reduced equity base. I imagine the shares of these companies in most cases will become very boring before they become attractive.’

Source: Michael Burry, Scion Capital Q1 2008 investor’s letter

His points were of course ultimately, spot on. It is interesting however to reflect on these views today as the market attitude has clearly turned full circle. By that we observe investors in US banks today:

- Assume that lower returns on more capital-heavy balance sheets are here to stay
- Are ignoring the effects of capital retirement (in the same way they ignored the possible effects of dilution)
- Are underestimating the effect that the stabilisation or improvement in the housing sector can have on the wider economy and the banks vs. the same driver in the opposite direction in 2006-2010
- Investors’ are a long, long way from worrying about ‘missing the bottom’

More simply put, investors - including some great stock pickers - got *very very* badly burnt trying to identify value in the financial sector on the way down. As a result almost all are *very* nervous of doing so again and have labelled the sector - “un-investible”.

[Housing, employment and banking trends however all look a lot better](#)

Last summer Buffett suggested that he thought the unemployment rate would start to fall ahead of the election. Many dismissed him as having become a cheerleader for the US economy. Earlier this week on Page 2 of the JP Morgan’s Q3 results we saw this quote from Jamie Dimon prominently displayed:

“Importantly, we believe the housing market has turned the corner.”

Jamie Dimon Chairman /CEO JP Morgan

With information out over the last few months showing US house prices either stabilising or rising, housing starts picking up, reduced inventory levels and a high proportion of cash buyers we are not surprised by Mr. Dimon’s assessment. What is interesting to us is that others in financial markets are either dismissing this possibility too readily or have not considered what it might mean for the banking sector. Many (including Greenspan and Bernanke) misunderstood the relationship between housing values, banking and the wider economy in the boom years. It seems many are again doing so in the lean (or possibly recovery) ones we now find ourselves in. The effect the housing sector had on the wider economy was enormous and the effect of its stabilisation/ improvement we suggest are possibly greatly underestimated.

[Don’t listen to us - listen to those that know the sector far better](#)

Earlier in the year (see pieces attached) we tried not just to point out our views on this sector but those of others who we considered far better respected and better placed to assess it. Today we follow up on this argument with some quotes from this weeks’ US bank results - see the end of this note.

From their results and conference calls both JPM and Wells give a clear picture of a housing improvement and the lower one-off costs they will incur as a result via less mortgage restructuring costs and write downs. A sceptical view of their figures however suggests that the better profitability they are now seeing due to significant mortgage refinancing activity should maybe be discounted because:

- a) Their recently increased market shares in that sector - we observe that survivors have gained both market share and credibility in the customer eyes and these positions are unlikely to reverse; and
- b) The greater volume of the refinancing activity being assumed to eventually fade once the process has run its course. When it does, the bears assert, these groups will be back to lower margins on lower volumes

This latter point is of course correct only if the US economy remains depressed. But the whole point of money printing and the actions it creates via significant refinancing activity is to reduce the burden on households due to lower interest costs and debt and thus improve consumer finances removing the drag they have been on the economy. These highly experienced and well placed bankers inside JPM, Wells and B of A seem to observe that these and other measures might be working to improve the market and the overall economy. We are inclined to agree. As such Jamie Dimon concluded:

“I think as long as rates stay low, refi will stay high. And volume will be high and very high volume clogs up the system and allows higher pricing. I think that once you start to

see rates go up, which personally I think will happen sometime in 2013, but I don't know, you're going to see lower refi and more competitive pricing"

Jamie Dimon JPM Q3 conference call (our underlying)

If he is right, the amount of refinancing activity will likely recede, but importantly this only happens if interest rates are beginning to rise/normalise and with them bank margins will start to improve. What price the US banks sector and even the dollar then...? Please look at the longer JPM quotes we have extracted from their conference calls at the bottom of this piece.

Goldmans + BONY + Bank America

Our view on these shares remains the same as articulated in April and August. In most investors eyes Goldman remains the pariah but that has not stopped the shares rising 30% in 3 months from a 25% discount to tangible book to much closer to it today. In short Goldman Q3 results showed it is making a (still unexciting) 8.6% annualised ROE and now trading on c.10x this Net income figure post the share price rise. We observe that were the group to return to a 15% ROE (hardly demanding as a leader in the field of branded corporate advice where the greatest cost is people) its PE would fall to under 6x. How is it possible to improve returns in a business without growing the top line aggressively? Improve efficiency and retire stock with excess capital. Goldman (and BONY) are doing both.

'In the second quarter of 2011, we announced a \$1.2 billion expense reduction initiative. Since that initial announcement, we've increased the target expense savings by nearly 60% to \$1.9 billion. We believe that we've been able to undertake these initiatives without materially impacting our client franchise. And as a consequence, we should be well positioned to create operating leverage in an improved economic environment.'

David A. Viniar CFO Goldman Sachs – Q3 2012 earnings conference call

Despite investor fears of lower returns forever, such actions suggest operating leverage to any improvement in demand could in fact be significant. Goldman's also pointed out that they will see risk weighted assets fall by 20% by 2015 as some assets roll off their balance sheet and are thus likely to have a sufficient buffer over the Basel III requirements to purchase stock or pay a dividend with most of their future net income. For those that like to look at marginal rates of return they could be very high at Goldman. We also continue to hold the view that many have left this industry seen by so many now as 'dirty investment banking'. The remaining leaders are making acceptable returns today and these returns could rise significantly with a following economic wind. Stranger things have happened.

Bank of New York Mellon and Bank America highlighted some other trends that are interesting

Bank of New York (BONY) reported Q3 numbers and made a 22% Return on Tangible assets. They did this despite a poor volume environment in clearing and low stock market volumes whilst experiencing like others a poor net interest margin environment. They too are a people and technology centric business like Goldman and are thus cutting costs to become more efficient. They are also building capital fast and Basel III Tier one capital has risen from only 6.5% a year ago to 9.3% today. This is occurring partly due to the current returns being good. But also due to a trend many of the banks are seeing; a rising value of the assets they already own and the ability to roll off some of the assessed higher risk assets that attract much regularity capital. What to do with all this capital? Why, buy stock back of course. They are obliging.

Finally Bank of America also reported yesterday and also saw a strong build in its capital ratio, it now having an estimated Basel III Tier 1 ratio of 8.97%. This is from a level of c.8% last quarter and from a bank which some investors worried about having a capital shortfall only a year ago. These speedy raises in capital ratios are in some case due to retained earnings but in others due to rises in asset values or disposals/run offs.

Like the consumer Refi activity these reasons for capital build are all arguably knock on consequences of money printing with bank shareholders ultimately being the beneficiaries. At the same time most of the companies we discuss here are pursuing very similar, highly shareholder beneficial business strategies; i.e.:

- Any prospects of acquisitions are mostly dismissed
- There is a clear focus on improved efficiency of core operations
- Some non-core assets are being sold
- Capital levels are being built quickly via the mechanism we describe above and it is targeted to be returned when appropriate

We suggest this is music to the ears of those that look for margins of safety and high marginal return on capital. It is also a far cry from the ego fuelled acquiring banks of 5-10 year ago and the equally optimistic share ratings that accompanied them.

In summary

We think this sector looks the most mis-priced big sector globally. Would we like to own industrial companies instead of banks that might be able to earn 13% on tangible capital one day? Of course, but none that we can find are priced anywhere near tangible capital, let alone the 30-50% discounts that some of the deep value US financials like BAC or AIG trade at. Equally there are few high quality compounding franchises left globally that can be bought for a PE of 10x as BONY, Wells and JP Morgan are currently priced and higher marginal returns might come for free.

The caveat, that should be clear to you as investors, is our distance to this sector and our more superficial level of knowledge vs. a lifelong banks analyst. We will observe that this different perspective has helped us in the past especially at times when the economic changes and industry trend intertwined so importantly as they did in 2008 and look to be doing so again today.

A more exciting way to make a bet on this sector

We have looked at some long dated warrants (2018-2021) in JP Morgan, Wells Fargo, Bank of America, AIG and The Hartford Financial group and consider them very attractive.

These were issued when the US Treasury gave these institutions capital through the TARP programme. Since then the Treasury has sold these warrants and they are available to investors.

The attractions of these warrants can be summarised as follows:

- They are very long-dated (7-9 years from expiration)
- The strike prices are not demanding given their maturity
- They have the added spice of having BOTH:
 - the strike price adjusted DOWNWARDS; and
 - the ratio of warrants to shares adjusted UPWARDS
 for any dividends paid by the companies before maturity

Please get in contact if you would like to talk more about them and see our modelling of them.

A few telling quotes from JPM call

Yes. So, Glenn, maybe I can separate it out. On the Mortgage reserve side, what we said in outlook is, if the trends continue the way we are, you should expect to see more reserve releases.. - Douglas L. Braunstein JP Morgan CFO

'The only other thing I want to point about capital, the 8.4% Basel III, which, obviously, is an estimate upfront phases in everything that we know of today. It does not phase in what we know about our own runoff and the ability to create new models down the road that reduce it. So I -- we would estimate, if you did all that, we're close to 9.5%.' Jamie Dimon Chairman /CEO

“Analyst - *How do you think about sort of this idea that in the near term, clearly, you're going to mint a lot of extra money on the Mortgage refi boom, but once that's behind you, you're simply left with a lower margin? Is that -- how much does that concern you or not?*

Dimon - *Not a lot. If you look at -- the margins in production are very high. They're well over like 2%, and a norm would be under 1%. So obviously, one day, that'll normalize. And in the meantime, you get volume and higher spreads. On the other hand, we have huge excess servicing costs, which probably would more than offset that. And with housing recovers, charges will come down. So to me, if the economy gets better, we're fine. You lose some production income, but everything else will be better.*

Analyst - *And then finally, there's a lot of big banks that are sort of framing a component of their operating expenses that they think is abnormally high right now based on the extra Mortgage servicing, the foreclosure, all the things related to continuing through the end of this credit cycle. Is there any sort of number or sort of range that you would think that we should think about for JPMorgan in terms of this excess Mortgage-related costs coming down as housing continues to recover?*

Dimon - *I think the big one to look at is the excess servicing cost due to the high level of default and the high cost of default and the consent orders and look at that number, it's about \$500 million a quarter; it's a little more than that. That number will eventually be 0. But I don't think it's going to go down to 0 – it'll probably take 8 quarters before it goes down to a number approaching 0, maybe more. It's going to take a while to work through all of that. But that number will disappear.*

'We've got a great company, we've got huge cash flows, huge capability, and we could probably buy back a lot of stock next year and still get the 9.5% Basel III at one point. And so I think the rational thing to do is if the stock is at the right price to buy back stock, obviously, we're going to apply. We don't know -- the CCAR rules will change next year, so when we see those rules, we'll decide'. Jamie Dimon Chairman /CEO

Source: Holland Advisors / Capital IQ – JP Morgan Q3 2012 Conference call

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Directors of Holland Advisors or the companies they advise have an interest in Bank of New York Mellon and Goldman Sachs shares and some of the TARP warrants highlighted.

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