Letter to Clients
April 2012

Springtime for Banking!

"Because that's where the money is."

Attributed to Willie Sutton

First, a bold assertion: in the history of western civilization, there has been no prolonged period when bankers have not been able to make money – and not just any kind of money but really, really good money. Which leads us to our not-so-bold conclusion: owning banks is quite a decent way to make money as an investor. The resilience of bankers' incomes may not be fair (though we decline to take sides on that one), but it is most certainly real. The flip side, of course, is that banks as a rule tend not to be so good about getting up from the feast once more measured diners would have been satiated. This financial gluttony leads to both systemic problems (they hold the power both to grease the wheels of commerce and to lead them to a grinding halt) and to the individual risk of a bank failure. Without pretty robust controls on how they operate, banks are in an unparalleled position to wreak tremendous havoc on customers, economies, and investors alike. This leads us to our second – but critical – conclusion: in order to own banks safely, you have to be careful to own the right banks.

To say that banks have been unpopular for the last several years is a substantial understatement. More accurately, they've been reviled – both by the media and by investors. While the mere fact of their survival has catapulted certain erstwhile hated names (Citigroup, Bank of America) to multi-year highs of late, they are still trading at a fraction of the prices at which they traded pre-crisis. The consensus seems to have coalesced around two fears: banks haven't yet fully paid the piper (i.e., there will be more defaults, fines, judgments and settlements to pay) and banks face a retooled and less lucrative future, thanks to abundant and constricting new regulation and tougher capital standards.

To really understand whether an industry is no longer a good destination for investment dollars, you need to analyze two things: the long-term impact of events on the business and the consequences to the competitive dynamics within the industry. It is becoming increasingly clear both that the enduring damage to the banking business resulting from the mortgage meltdown, while palpable, has been overstated and that the financial crisis has differentially affected the surviving institutions and actually worked to enhance the competitive standing of certain members of the industry. The end result is an industry that will have somewhat muted returns but less volatility, with certain players more dominant than others.

To be sure, bad things really did happen to banks over the past four years. People and companies borrowed money they shouldn't have and failed to pay it back. The lion's share of this overextension of credit and attendant default by borrowers was in subprime and other home mortgages, but credit card debt, cash flow business loans, and even auto loans, having been made too freely in heady times, also played cameo roles in helping to fuel the financial crisis. In

addition, the banks have been confronted with (and continue to face) a raft of lawsuits from individuals, pension and hedge funds, and government bodies. The exact financial (and reputational) toll those will take has yet to be determined. And finally, regulation has indeed gotten much tougher and far more granular in terms of the kinds of behaviors it seeks to prohibit or control.

But while the litany of actual woes is lengthy, it stops far short of the dire predictions that were accepted as gospel by the financial media not too long ago: these include the "tsunami" of home equity loan defaults that did not occur, the "tsunami" of strategic first mortgage defaults (ditto), and the "tsunami" of commercial real estate loan defaults (double ditto). Indeed, as we move further away in time from the implosion of the system in 2008 and early 2009, each of these becomes less and less likely to eventuate. As we survey from today's vantage point the admittedly distressing wave of increased defaults, foreclosures, and legal costs, it is clear that the pace of resolution has accelerated and the pace of new negative developments has slowed. Barring a new set of events that might reignite the conflagration (and it is difficult to imagine that distant events such as Europe's fiscal messes will be the kindling that sets light to such a fire, though a fragile economy can be tipped over by even modestly negative events[1]), it is hard to argue that things aren't starting to settle down. Bad loans are running off quickly; for Wells Fargo and US Bancorp, annualized net charge-offs at the end of the first quarter of 2012 were running at 1.25% and 1.09% of loans, respectively, compared to a pre-crisis rate of around 1%. At their peak in the first quarter of 2010, charge-offs hit 2.71% and 2.39%, respectively. While foreclosures slowed down as a result of the "robo-signing" debacle, they have recommenced and are proceeding apace. Litigation reserves (which represent a bank's best estimate of "probable and estimable" losses), while an imperfect proxy for the amount of real exposure a bank has to private and public legal matters, are very manageable, and have remained relatively stable. Actual losses – including the $5.3 billion Wells will pay pursuant to the settlement with the Attorneys General announced in February – have been well within the bounds of affordability and were substantially reserved for. Neither Wells nor US Bancorp (which has essentially no litigation reserves to speak of) deems the worst likely outcome of any litigation arising out of the financial crisis (which, in Wells's case relate mainly to activities engaged in by Wachovia) to be material either individually or in the aggregate to its financial position. Goldman Sachs, the litigation magnet of choice, is similarly sanguine about its litigation outlook, and we tend to believe them.[2]

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[1] While the knock-on effects of European fiscal mismanagement are hard to predict, there has been ample time for counterparties to get their houses in order. Moreover, while Europe may loom large in the popular consciousness as a trading partner, it represents a surprisingly small percentage of U.S. trade. On the other side of the ledger, the precarious position of many European banks provides an opportunity for healthy U.S. banks, both in terms of being able to exploit the vacuum left by the retrenchment of the European banks and also in terms of their ability to buy good assets off the latters' books at depressed prices.

[2] We are still in the early stages of much of the litigation associated with the mortgage meltdown, and while it is impossible to know for certain, we believe that Goldman will have reasonable success narrowing the claims against it in the later stages of litigation and settling cases at the lower end of its range of possible exposure. Specifically, we think that plaintiffs will have difficulty proving causation (i.e., that it was Goldman's actions and not the unanticipated implosion of housing that actually caused the losses), demonstrating damages (to the extent that declines in the value of some of the securities in question were temporary), and asserting that they were not sophisticated players under the law. However, the sheer amount of litigation Goldman faces in this area, the uncertainty as to the number of additional individual suits it may face, and the uncertainty that arises from further SEC enforcement action against Goldman necessarily creates increasing risk that the toll could be significant, if not long-term material.

Perhaps more difficult to reconcile with popular sentiment and the recent memory of the serial shocks of the Bear Stearns and Lehman Brothers implosions, the Reserve Primary Fund's breaking of the buck, and the resultant government intervention is that some of the events of the last four years were downright advantageous to a handful of banks – those representing better-run franchises whose legacy issues were less pronounced. Catastrophes are Darwinian events, and the financial crisis was no exception: numerous institutions – those that consistently underpriced risk – failed, either explicitly like Indy Mac or implicitly when folded into stronger institutions, like Countrywide, Washington Mutual, and Wachovia. Those that remained have fallen into three post-apocalypse camps: those made relatively stronger by the reduction in competition; those continuing to struggle, damaged by the events of the last four years; and those, while relatively healthy, that are locked in a competitive struggle within their weight class but without a differentiated value proposition and no comparative advantages versus their rivals (we would put smaller community banks as well as regional players like Comerica and BB&T in this camp).

The combination of weak and undifferentiated competition has meant that the strongest and most distinctive institutions are continuing to consolidate their share gains, bulking up while their competitors eke out a subsistence living. It is noteworthy that as of yearend 2011, Wells Fargo commanded 9% of U.S. deposits, a 175% increase from the third quarter of 2007. US Bancorp's deposit base grew 88% over that same timeframe.[3] In an industry in which scale confers enormous cost and deposit-gathering advantages, national scale and dominant positions within submarkets lead to a virtuous cycle of success to the successful: higher net interest margins, stronger and more durable capital generation engines, and a better ability to develop and maintain sticky customer relationships that are essential to success in what, at bottom, is a commodity business. National scope and a diversity of financial products attract customers who tend to have more complex (and therefore typically more lucrative) needs. The multiplicity of connections in turn tie the customer more closely to the institution, both making it more difficult to switch to another bank and making it easier for the bank to understand the client as a credit risk and potential consumer of additional products. A more diversified business model also tends to dampen earnings volatility and strengthen resilience over cycles. Scale allows a company to better absorb fixed costs and, literally, to "scale up" so that they can keep more of each incremental dollar earned than their smaller counterparts. This becomes especially critical in businesses that demand such scale, such as mortgage servicing, where the blocking-and-tackling infrastructure is sufficiently costly and complex as to make the business uneconomic for all but the largest companies. While there are also diseconomies of scale in terms of management layers and complexity, a well-run organization like Wells has the capacity to overcome those.

At its core, banking links up savers (depositors) and borrowers. Home buyers, small businesses, students – pretty much anyone other than large corporations or other institutions that are able to tap into the capital markets directly[4] – that need capital need to access it via the banking system. Love them or hate them, banks are a critical part of a market economy and the process of capital formation that allows the economy to thrive. Those who assert that the need to carry more capital (and therefore use less leverage) ineluctably leads to much lower

[3] Note that some of these new deposits are being "parked" by corporations pending the revival of the economy and will likely be withdrawn when they have something better to do with them.

[4] Despite record low interest rates, capital markets activities for those with access to the securities markets have been moderate lately as a function both of suppressed economic activity and the overflowing cash coffers held in reserve. Once the economy revives and that cash is inadequate to meet needs, we would expect to see a normalized level of activity in those markets.

returns on capital have missed a key step: as the pool of capital available for lending shrinks, the cost of capital for borrowers increases. While returns might not revisit pre-crisis levels, this compensating price mechanism will likely go some perceptible distance in mitigating the impact of higher capital standards. Similarly, it is indisputable that the new Dodd-Frank regulations will impose a significant amount of administrative costs on the industry as a whole; as a competitive matter, however, those costs will not be distributed evenly – for two reasons. First, those institutions that have always been better run will be in much better position to adopt and maintain new regulatory standards, thereby burdening them proportionately less in terms of additional costs associated with compliance. Second, those with scale can better leverage that scale in absorbing the attendant costs. While there continue to be some financial intermediaries that elude the full panoply of banking regulation (e.g., hedge funds, which have never purported to carry out the functions of a traditional bank), Dodd-Frank actually went some distance toward leveling the playing field with non-bank entities such as mortgage brokers, who now must meet standards set by the Consumer Financial Protection Bureau. Set against the full competitive background, both capital and regulatory enhancements actually confer advantages to large, well run banking institutions.

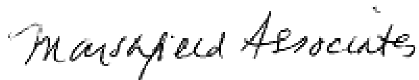
So where does that leave us and how can we tell if our bets are correct? Because the stock market is still preoccupied with the meta-story (Banks have to hold more capital! Banks can't engage in proprietary trading!), the stock price of banks is a poor proxy for their health and future prospects. The better guide to bank vigor and opportunity is growth in book value per share. Book value is a measure of bank equity; it informs such regulatory decisions as how much lending and other activities a bank can engage in. Over long periods of time, consistent growth in book value indicates both a bank's stability and also the truthfulness and judgment of bank management; banks that have an inflated view of asset values might look like they have high book values and a nice trajectory in growth in book value. But over time, overestimates of asset values and underestimates of measures like nonperforming loans will out, and book value will reflect that. While Bank of America and Wells Fargo were in most of the same businesses before the financial crisis (albeit with a different footprint), B of A lost 34% of its book value per share between September 2007, just before the meltdown began, and the end of 2011. Wells' BVPS, by contrast, gained 73% over that timeframe. Likewise, though Citigroup was less focused on home mortgages, it lost 76% of its BVPS over that same period, just as US Bancorp's gained 44%. If book value is real, then growth in book value per share tends to reflect growth in intrinsic value per share, which is where the rubber hits the road for investors like us. There is, moreover, a virtuous circle that tends to ensue, particularly in times of less fear: banks that are honest about book value and consistently grow it are typically rewarded over time with higher multiples. Management integrity, a culture of honestly reflecting on their balance sheet what actually exists, and a focus on getting things right are the critical differentiating factors.

We've already alluded to some of the things we think are likely to play out going forward: elimination of the most reckless competitors will continue to drive share gains and a flight to quality by depositors; higher capital standards will increase the cost of capital, allowing banks to recoup at least some of the returns they will give up as a result of the lower leverage; and enhanced regulatory burdens will favor the better equipped and larger in scale. Like it or not, unless there are ready substitutes that cause an industry to risk losing its customers, increased costs of doing business typically get passed on – at least to some extent – to those customers. Regulatory costs are no different. The reduction in interchange fees for debit cards ushered in by the Durbin Amendment will likely be reflected in reduced (or completely eliminated) debit rewards. What will likely increase for everyone will be more explicit charges for services. While Bank of America's ham-handed attempt at charging a fee for debit transactions was roundly

denounced by customers and subsequently withdrawn, it is clear that banks are actively seeking a way to recoup some of their increased costs. And the odds are strongly in favor of them discovering some way to do so. As it is, Wells and US Bancorp reported record annual earnings for 2011 and record first quarter earnings for the first quarter of 2012. For Wells, its quarterly revenue was the highest in nine quarters, with record diluted EPS and a return on assets of 1.31 percent, the highest since the first quarter of 2008. Return on equity of 12.14%, while by no means heroic by historic measures, was the highest since the second quarter of 2009. Surpassing that was US Bancorp, an avowedly conservative (some might say stodgy) institution that sidestepped much of the crisis, with a return on equity during the first quarter of this year of over 16%. It is difficult to poormouth such results, especially in an environment of extremely low interest rates, with the residue of the financial crisis continuing to represent a drag on overall performance.

Increased regulation will also generate some less intended consequences that, while not negative for banks, may be less appealing for society: the extension of credit to less affluent people will likely become more constrained, as will the availability of consumer credit. Even the so-called "crackdown" on mortgage origination and servicing abuses has done little other than to hasten the exit of less committed players from the business, leaving what is a very good and highly scalable business to a handful of large players, Wells Fargo among them. Wells now accounts for almost 18% of the servicing market and owns about 30% of the new mortgage origination market. If the intent of reregulation was to limit the scope of banks and the concentration of services in a few hands, it certainly missed its mark. While we don't anticipate that the industry will come anywhere close to the level of concentration seen in other countries, we don't expect that such increased power among a smaller crowd will be a negative development for the profitability of the select remaining institutions.[5]

As the economy continues on the path of gradual (and probably uneven) recovery and as borrowers dig out from the staggering amounts of debt they amassed during the boom years, banks will once again be called upon to make mortgages, extend credit to small businesses, and facilitate the day-to-day transactions that underpin a complex market economy. It may be a while before we see times return to "normal", much less to the frothy days of the early part of this century, but we are very willing to bet that bankers – and the institutions for which they work – will continue to be paid quite well. The difference this time around might be that there will be fewer of them and they will be far more likely to be working for banks of substantial size and scope rather than those with smaller reach and breadth.



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[5] Countries like Canada, which have a small number of pretty profitable banks, have been fortunate in having a reasonably healthy system over time. European countries, which also tend to have a handful of banks, have been less successful with this model, perhaps in part because of the quasi-public nature of some of those institutions, which have been used to pursue policies apart from arms-length banking.

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