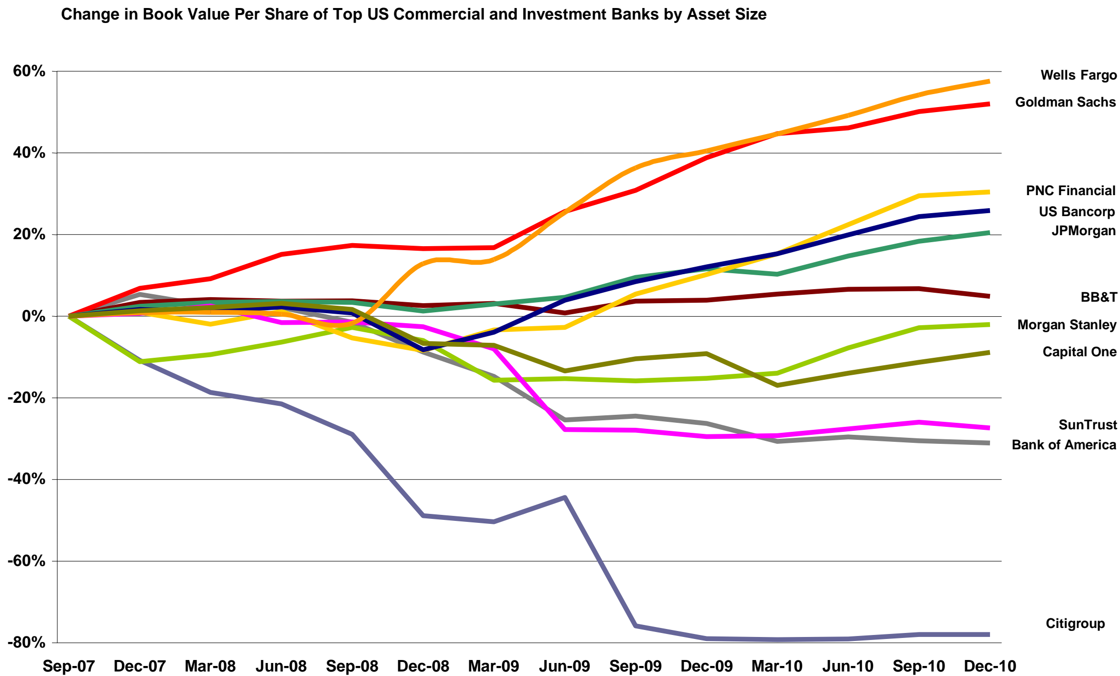
Letter to Clients
February, 2011

Book 'em, Danno

"You have your story, I have mine."

The Big Lebowski



If a picture is worth a thousand words, then this chart should allow us to write a short newsletter. It shows the change in book value per share[1] since the beginning of the financial crisis for a group of well-known commercial and investment banks.[2] We own or have owned some of them. We don't own and haven't owned others. As we see it, this chart makes two important points. First, not all financial companies are managed equally well, nor do they perform equally well, especially in extremely stressful environments. In fact, the contest is not even close. Management matters. Culture matters tremendously. The worst of the companies we show here, Citigroup, lost 78 percent in book value per share during the last three and a half years. The best, Wells Fargo, gained 58 percent. You might be excused for thinking otherwise if you just read the newspapers or listen to "analysts".

[1] Book value is simply shareholders' equity, that is, a corporation's assets minus its liabilities. Book value per se is an inexact proxy for a bank's intrinsic value for two reasons. First, book value reflects the truthfulness and judgment of a bank's management. It is therefore reliable if the management is intelligent and has integrity, but not otherwise. Second, a bank is worth more or less than its book value depending on the long-term return that it is able to earn on book. However, growth in book value per share is a pretty good proxy for growth in intrinsic value per share, again assuming intelligence and integrity. Book value matters particularly to banks since book value-like measures of bank capital determine how much lending and other business regulators allow a given bank to do (a growing book value means more lending is allowed, presumably leading to higher earnings).
[2] Absent from the chart is a depiction of the decline of book value to zero that happened to erstwhile value investor darlings such as Washington Mutual.

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Second, Marshfield has consistently been able to choose the better companies among these firms. We owned only one bank though the crisis: Wells Fargo. With the benefit of hindsight, that looks like a pretty good choice. In addition, we purchased a small position in U.S. Bancorp (up 26 percent in book value per share in the last 3½ years) starting in the second half of 2008 and increasing that position in early 2009; we bought a very small position in J. P. Morgan (up 20 percent) starting in April 2009; and we built a substantial position in Goldman Sachs (up 52 percent) in 2010, starting out small during the first Greek crisis and increasing the size significantly during the SEC furor. All of these positions were purchased at small premiums to book. Our only decision with which one could take issue, we believe, was our on-again, off-again flirtation with Citigroup. We sold half that position in August 2007, when Citi finally decided to disclose its SIV exposure and before the downturn really began. We then sold the remaining half in October and November 2007, as the crisis was just starting.[3] When we see significant anomalies we don't hesitate to take action.

We build our portfolios on misconceptions and the pricing errors that result from them. The most obvious such misconception that applies to banks is, as noted, the notion that all banks are the same. There are a lot of other misconceptions about banks currently, but here are some of the more widely held:

- "Extend and pretend", i.e., that banks are hiding large amounts of non-performing loans (think commercial real estate) on their balance sheets and refusing to either properly mark them down or sell them. First, catchphrases are poor substitutes for thinking. Second, some banks tell the truth and some don't. Only those that tell the truth can run their business properly; if you don't admit to yourself that a loan is bad, then you'll make that kind of loan again. Third, believe it or not, it can actually make sense as a business decision to hold a properly marked-down loan or asset through a time of economic stress and sell it when markets are more liquid and more optimistic. So, to sum up, our banks may "extend" but they certainly don't "pretend".[4]
- Banks have had a difficult time generating revenue in the last few years (true) and will continue to have difficulty for several more years (probably not true). Banks have reduced revenue for two reasons. First, the economy has been slow[5] and there has been less demand for credit and credit-related products. When the economy gets better, and it may be getting better now, demand will improve. Second, regulators have increased banks' capital requirements. While banks are increasing their capital ratios, they can't at the same time easily increase loans. That process, we believe, is substantially complete. When it is, banks will be free to grow their assets and revenues.
- The "lump of capital" idea, which goes something like this: historically, banks earned revenues in certain areas and allocated capital accordingly. New legislation and regulations are reducing the amount of revenue banks can earn in some areas, and at the same time increasing banks' capital requirements overall. Banks will therefore earn lower returns. We don't

[3] This was a classic investment error. We had made money buying and then selling Citigroup twice before, in the late 1990's and in 2002-2003. The best that can be said of the third time was that we managed not to lose very much money.
[4] Many of the same people who believe in "extend and pretend" are also big fans of distressed real estate funds, somehow believing that banks' "toxic assets" magically become great investments as soon as they are transferred to hedge funds. So far, this has not happened.
[5] This falls into the category of the blindingly obvious.

think this is true. Banks are – and there is much outrage at this – finding ways to replace lost revenue. Bank capital, unlike, for example, automakers' capital, is fungible, so that if returns in some parts of their business are diminished, the capital can be reallocated to other areas or returned to shareholders. This is what we believe will happen at Goldman Sachs, however the Volcker rule is ultimately applied to proprietary trading activities: capital will migrate within the firm to where it can generate acceptable returns – or it will be returned to shareholders in some form. And to the extent that more capital is required generally, margins will increase correspondingly, simply reflecting the lower availability of credit.

As a final thought, it's worth noting that we came up with the idea for this chart at a recent banking conference after hearing John Stumpf, CEO of Wells Fargo, speak. One thing he said stuck with us: "Not all financial services companies are created equal." Exactly our point as well.

We don't attend many industry conferences. They've always struck us as events where most companies that make presentations tell lies about their results and prospects and then answer softball or pointless questions. By contrast, we for the most part prefer to talk to our companies and their competitors one at a time, asking our own questions, most of which we hope are meaningful hardballs. Nonetheless, conferences do allow us to see companies in a given industry present one after another, so that it is possible for us to identify consistencies and inconsistencies. The conference we attended recently helped cement for us the conclusions we take from our graph. Moreover, the parade of CEOs, while each one delivers choreographed remarks, can provide interesting insights into character if you are inclined, as we are, to focus on such things. So, on the one hand you had the CEO of a bank we won't name who had just been struck by laryngitis that morning (no, we're not making this up) and so had to leave a long recitation of half-truths to an underling. On the other hand, you had Richard Davis, CEO of U.S. Bancorp, whose talk was characterized by his usual crispness of manner and thought. If you could chart a company's character, we know which one we'd show in the ascendant.

Past isn't always prologue in investing. Products go out of style, as is happening today with newspapers. Competitors or customers become more powerful, as those who sell to or compete with Wal-Mart have discovered. Character, however, abides.

Marshfield Associates

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