Monthly Investment Commentary

Commonwealth Bank & Trust Company

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Encouraging economic news in February continued to drive positive stock market returns, with the large-cap S&P 500 index (up 4.3%) posting its third straight month of gains. Returns were stronger overseas with both developed and emerging-markets stocks gaining over 5%. High-quality domestic bonds were flat for the month, while international bonds fell nearly a percent.

Assessing Risks and Opportunities in the Financial Sector

The financial sector, and banking in particular, has been a source of significant disagreement within the investment community in recent years. Some see compelling opportunities for patient investors. Others believe the underlying complexity and macroeconomic risks, such as the ongoing debt crisis in Europe, make the sector a challenge to analyze with confidence. We want to better understand some of the risks and opportunities in this important sector because it helps our research efforts in a few important ways. First, it helps in our evaluation of various asset classes, particularly stocks and bonds. Secondly, we regularly evaluate outside managers and it improves our ongoing due diligence on managers, especially those who own banks in their portfolios. Lastly, as equity managers ourselves it gives us key insights into the sector which can improve the "hit-ratio" of our individual picks.

In general, we have been underweight the financial sector in portfolios since 2007, which has been a general benefit to our clients, and portfolio returns. That being said, we do not want to blindly avoid the sector and bypass selective bargains that can improve returns to our investors going forward. In uncertain times, it can be beneficial to gain perspective from other experienced and well respected managers. Therefore, we are sharing with you an interview that one of our research providers, Advisorintelligence.com, has recently conducted an interview with two well respected managers on their outlook for the financial sector. The managers offer contrasting views on the outlook for the sector, and we thought you would find it of interest and insightful.

Below is a summary of the separate in-depth discussions with portfolio managers from two fund management teams—Chris Davis and Ken Feinberg of Clipper and Selected American Shares, and Pat English of FMI Large Cap—who have historically exhibited different views toward banks. The discussions have been combined into one "virtual panel" in order to better compare and contrast the managers' views on banking and financial stocks.

Christopher C. Davis and **Kenneth Feinberg** are portfolio managers for the Davis Large Cap Value Portfolios. Davis joined Davis Advisors in 1989 and has more than 22 years of experience in investment management and securities research. Feinberg joined Davis Advisors in 1994 and has 17 years of experience in the investment industry.

Patrick J. English is the chief executive officer and chief investment officer of Fiduciary Management Inc. (FMI). He joined the firm in 1986 and has 27 years of experience in the investment industry.

Q: What was your approach to investing in banks prior to the credit crisis?

English: I would say that generally we haven't ever liked the banking industry for a couple of reasons. To begin with, the only way [the banking business model] works is to be highly levered. I think that increases the risk profile. If you look at banking over a long, long period of time, when there's action in the marketplace and when credit is being extended and growth is out there, the bankers

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fall all over themselves to make loans. You don't really know where you are in the cycle until it's too late. But nobody wants to give up market share. So, you end up putting a lot of bad business on the books.

If you go back over the last 25 years, [banking has] never been an area where we've ever been close to a market weighting. But, from time to time there have been some regional lenders that have looked interesting, are conservatively managed, and have a track record of reserving adequately. Occasionally, when the stocks are cheap and when we have a company with a proven track record that isn't taking a lot of black-box risk, we have purchased those companies. Certainly today we have one in Comerica.

FMI Large Cap Financial Exposure (12/31/11)

Financial Holding	% of Financials	% of Total Portfolio
Berkshire Hathaway Class B	24.2%	3.9%
Bank of New York Mellon	23.0%	3.7%
Comerica	19.3%	3.1%
American Express	17.6%	2.9%
Willis Group Holdings	15.8%	2.6%
Total	**100.0%**	**16.2%**

Q: Has your approach to investing in banks changed since the credit crisis?

Davis: Yes! I would say one of the most frightening things about this crisis was to listen to a senator say that it may be better for the financial system to simply nationalize all the large banks. I definitely think we learned that irrational things can happen and can overwhelm the underlying economic reality. I would put very, very low probabilities on that now—we've gone through the crisis, right? The capital ratios are way higher. The reserves are way higher. Asset values are way down. The idea of being blindsided, I think, is way lower now.

I think it was a huge lesson about core funding, about regulatory risk, about mark-to-market dangers, about being forced sellers. We've also learned really great lessons about underwriting cultures, about owning your own assets, controlling your own distribution, controlling your own funding.

Feinberg: I'm not a big fan of banks with trillion-dollar asset portfolios. You see what happens with companies like Citigroup. One guy makes an agreement that's called a liquidity put, [where Citigroup] funds this hedge fund with short-term funding, and they guarantee that if Citi cannot roll over the short-term funding, the hedge fund could just give the assets back to Citi at par. So they get the deal done. I'm sure the guy got a nice bonus for having this big relationship. But, that one piece of paper cost Citi $9 billion and management didn't even know about it! No one knew about it! That's why I don't like trillionaires. And, I don't like investment banks. They're all about greed and money and doing what's right for a 34-year-old guy and not about the shareholders. They don't own stock.

Then you have derivatives risk added onto that. You don't need those kinds of surprises. Buffett used to always talk about it—the bigger banks get, the [higher the] cost of foolishness. He said that 15 years ago. So, you just cannot police it, no matter how much you try.

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Q: When is typically a good time to make money in banks?

English: If we had perfect foresight, of course, we would buy them just as the economy was turning and they were trading at well below book. But, that's often hard to get on top of. I would say that there've been a few opportunities in the past where they've traded down to extremely low levels. I would think the early '90s, for example, was one period, and after the break in '08/'09 was another period. Then, more recently they've come under a cloud again.

Clipper Fund Financial Exposure (12/31/11)

Financial Holding	% of Financials	% of Total Portfolio
American Express	19.3%	10.5%
Oaktree Capital Group	17.9%	9.7%
Berkshire Hathaway Class A	14.5%	7.9%
Loews	11.8%	6.4%
Bank of New York Mellon	9.2%	5.0%
Transatlantic Holdings	9.1%	4.9%
Wells Fargo	4.0%	2.2%
RHJ International	3.4%	1.8%
Ameriprise Financial	3.2%	1.8%
Alleghany	2.3%	1.2%
Julius Baer Group	2.2%	1.2%
SKBHC Holding	1.2%	0.7%
Goldman Sachs Group	1.2%	0.6%
Cielo S.A.	0.9%	0.5%
Total	**100.0%**	**54.4%**

When we're in this space, we're looking for differentiated companies. We're looking for companies where we can assess the risk. I don't know how you can have a lot of confidence in the investments when you really can't assess the assets. Even today, you still have to have a pretty positive opinion on what's going to happen with real estate values to be positive on most of the big banks. We're just not really willing to make that bet right now, based on the fundamentals of the housing industry.

Q: Do you think that one has to be optimistic about real estate to be positive about banks?

Feinberg: I don't think you'd want to own banks if you imagined a steep leg-down [in real estate values], but I certainly don't think you need a recovery in real estate for them to be decent investments. The stabilization is the more important piece. We are not macro sort of investors, but I think if we felt there was another 20% or 25% leg down in single-family residential real estate, I don't think you'd want to own the banks. I don't think anyone would.

Davis: I would say rather than in the bullish camp about real estate, we're simply in the "not bearish" camp. And, Ken's right. If you get something better than stabilization and you have some recovery and you get new home building, then that's good for employment. You get that, then, of course you could get a much better outcome and you'd have enormously consolidated market share. So I think any recovery in asset values is good, and growing asset values is better, but all we need is for there not to be real deterioration.

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Q: Currently, what are your biggest concerns about investing in banks?

English: I would say that just because a risk is talked about doesn't mean it's always embedded in the stock. I'm amazed right now that the stock market seems to be shrugging off what's going on in Europe. I don't think there's any way Europe gets through this crisis without a significant bank problem. The fact that Greece is in the news every day is not going to save Greece. They think that $140 billion or $170 billion is going to hold Greece until 2014. I'd give that a 1-in-10 chance. Based on the information we're reading about Greece—about their competitiveness, where their wage rates would have to go to make them more competitive, and the fact that companies will have to relocate there to take advantage of that cheap labor—there are so many "ifs" to even get anything approaching a zero-percent GDP growth in Greece. I don't know how they're possibly not going to default.

The European banks own a lot of the sovereign debt of each other. The American banks own debt in the European banks. Something like 40% of the money market funds own European bank debt. So, [U.S. banks] have huge exposure. But, you also have the fact that the Fed still has an open checkbook with the ECB [European Central Bank]. In the '08 crisis, Bernanke opened the Fed's checkbook to the ECB for emergency funding. As far as I know, that checkbook is still open. If the European Union starts to fall apart and they have a liquidity crisis, they're going to tap into the Fed. We're all connected. I think there's a nontrivial probability that we'll have another financial crisis.

Davis: The risk that gnaws at me is sort of a stagnation risk, because you have a lot of loans that are rolling off the books. Companies have record cash. So you have lower real estate values, then you have lower acceptable loan-to-value ratios. Those two compound and [become] huge [factors]. You just have less asset-volume out there. You have consumers taking on less credit in all different forms. And then in corporations, you have record cash generation and enormously strong balance sheets, so you're not getting a lot of growth in commercial debt. Commercial real estate is the same idea; [there are] generally lower appraisals and then lower leverage on lower appraisals with more equity being required. All of that means when you think of the balance sheet on the asset side, you have fewer assets. And, on the liability side, of course you've got all these low-cost deposits, but if your loans don't grow, your spreads are going to narrow.

There are offsets, though. You have great loan growth from market share. You've put the nonbank sector out of business for the time being—the shadow-[banking] folk—[and] you have growth from that. And, then you have growth from market share of the consolidated remaining banks. You've got less competition, which should mean that what loans are made, are made not just on better terms and conditions, but at better interest rates. So, there's some offset there. But, I think my greatest worry is that spreads continue to compress as assets roll off, and [banks] don't have anything to do with the money. In fact, one of the great things about the crisis in Europe is banks like Wells Fargo can look over there at pools of loans where the banks need to free up capital, and can in essence buy loans, because they have very low-cost deposits.

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Q: If the Fed extends its current zero-rate policies for several years into the future, what will be the effect on banks' spread lending business?

English: We're dead! I mean, we think that the market will have something to say about it. We don't believe that's going to happen. [If it were to happen] it will not be good for Bank of New York and it's not good for Comerica. [The Fed] is going to try to pump this thing up; they're going to try to play their magic tricks. We'll see if the market continues to play the game. We've had an unprecedented run [of low interest rates] already. It's hard to say for sure how that's going to play out. I would say that at some point, you're going to have inflation. You're not going to be able to keep this genie in the bottle.

Selected American Shares Financial Exposure (12/31/11)

Financial Holding	% of Financials	% of Total Portfolio
Wells Fargo	17.8%	5.7%
American Express	16.5%	5.2%
Bank of New York Mellon	13.5%	4.3%
Loews	8.2%	2.6%
Progressive	7.4%	2.4%
Julius Baer Group	7.1%	2.3%
Berkshire Hathaway Class A	6.4%	2.0%
Transatlantic Holdings	4.3%	1.4%
Hang Lung Group	2.9%	0.9%
Fairfax Financial Holdings	2.8%	0.9%
Brookfield Asset Management	2.6%	0.8%
ACE	2.2%	0.7%
Ameriprise Financial	1.6%	0.5%
Visa Class A	1.6%	0.5%
Charles Schwab	1.3%	0.4%
Goldman Sachs Group	1.1%	0.4%
CME Group	0.6%	0.2%
JPMorgan Chase	0.5%	0.2%
Aon	0.5%	0.2%
Markel	0.5%	0.2%
Everest Re Group	0.5%	0.1%
Total	**100.0%**	**31.9%**

Davis: I think that banks can try to take advantage of the turmoil in the world, because in that sort of world that you described, there's going to be a lot of pain. That pain could get reflected in [some] banks' problems. Then [other banks] can become buyers of loans. Again, that sort of scenario is not disastrous for banks. It just means that you get earnings depression and lower returns on equity. But, if your return on equity is 7% and we thought it was going to be 12%, and we bought it at book value, that 7% is now all excess capital because there's no loan growth. That's not the worst thing in the world!

Q: How big will the negative impact of increased compliance and capital requirements be on banks' profits?

Davis: There are some [costs] that are going to persist for a very long time. If banks need to hold more capital, that's just simple math in terms of the impact on the ROE [return on equity: the amount of net income returned as a percentage of shareholders' equity]. The harder math is what these things will mean in terms of the constant chipping away at different parts of your business. One thing about regulatory costs is, there are some diseconomies of scale and some economies of scale. They cut both ways. The diseconomy of scale is if a bank is considered a "G-Sifi" [global systemically important financial institution], then it has to hold more capital. For [banks] on that list, all things being equal, ROE is going to be lower simply because

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they have to hold more capital. But, of course there are big economies of scale because the smaller banks just have an enormously difficult time complying [with new regulations].

I think the risk of constantly being ambushed by new adverse proposals will go down over time, but I wouldn't expect the capital ratios to go down over time. Once they simply stop going up, your earnings go from earnings that need to be retained to build your capital ratio to earnings that can be distributed. And, we think a lot about normalized dividend yields [when analyzing] these businesses.

English: I think at this point, what you have right now is a bill that's 848 pages long. There's probably going to be somewhere between 100 and 500 pages of clarifications and follow-up questions related just to the Volcker Rule. You have 400 new rules that have to be implemented, but only 93 have been finalized. We've just scratched the surface on all of the regulatory issues that are coming down the pike here on Dodd-Frank. It's hard to know exactly how that's going to play out. I think that it definitely slows and decreases the profitability of the industry significantly. Just in terms of how the banking industry evolved since the crisis, there's no question that it's more concentrated. Now, that's the irony of the whole thing. The government is very concerned about "too big to fail," yet they've created bigger and bigger banks. It's completely the opposite of what should be happening. So, we've now created more concentration. I think almost 60% of the assets now are tied up in six banks.

Q: Since banks are currently well-capitalized and leverage is low relative to history, are banks less risky now than they were prior to the crisis?

Davis: Dramatically less risky. This is the issue of risk versus the perception of risk. The more risky people feel things are, usually the less risky they are! It is the awareness of the risk that in fact lowers the risk. How can the banks be less risky when you've had enormous reductions in asset value, increases in capital ratios, and increases in reserves? It's through the elimination of a lot of the irrational competition and valuations that are cut, in most cases, in half. It's hard for me to even imagine how banks could be riskier now. You've had a huge mix shift toward higher-quality loans in the portfolio. Then, to the extent loans have rolled over, they've rolled over with better documentation, more collateral, and tighter terms and conditions.

English: I think from a capital perspective, you've seen across both banking and insurance what's deemed an A- or AA-rated balance sheet is much different now than it was historically. I think a little bit of the rules of the game have changed. Maybe that's logically related to the fact that the U.S. government has somewhat socialized the downside. One of the reasons the ROA [return on assets: an indicator of how profitable a company is relative to its total assets] spiked up so high is because of proprietary trading. That's going to be severely curtailed by Dodd-Frank. I think that's something to consider. The other thing to consider is leverage. The additional leverage the banks were able to put on their books by using off-balance sheet derivatives and juicing the book equity pretty significantly, is over. So, I don't think the profitability is going to be there. [Banks] are going to have to carry more capital; that's going to weigh them down. And these other avenues of growth have been taken away. They've taken away the profitability on debit-card exchange and potentially, credit-card interchange. [Profitability] is going to be okay, but I think it'll be quite a bit less than what it was in the last cycle. It argues for being pretty sanguine about where the multiples are going to go.

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Q: Would you ever buy Bank of America, JPMorgan, or the Citigroups of the world at any price, given the limitations about what you can really know of them?

Feinberg: It's very hard to generalize in the financial services. When things have so many challenges and they've been in the newspapers for so long, it's usually a good place to look. But, our personal preference is for more of the steady-eddy Wells Fargos of the world and less for the potential blockbuster turnaround, like a Bank of America. [At Wells Fargo], we really have always liked the management and we've gotten to know the management for literally over 13 years. Everyone that they appoint seems to be good—very humble, small egos, team players. That's rare in the lending culture.

Bank of America could be a really good stock over the next two years. I hope it is, because it's good for America. It's good for the world. Wells Fargo may be less stellar from a price performance comparison with Bank of America over two years, but they don't have the same challenges as Bank of America has and even that JPMorgan Chase or Citi has with all of the regulations that either are being written or have been written and implemented and consumer financial-protection agencies that are overlooking certain products.

One of the reasons that we don't own a lot of banks—again, with the caveat that they might be really good stocks—is because of all the uncertainties. It's harder to have great conviction that a business model will be what it used to be. In fact, you can almost guarantee it's going to be worse. And it has been worse. But, a lot of that is perhaps discounted by the market in some banks. Wells Fargo is sort of our favorite, in terms of "real" banks, but it's really a super-regional bank. It doesn't have all the global issues of Europe. This is going back a few months ago, before the ECB made liquidity much easier for the banks. That took a huge amount of the "tail-risk" off of the worst-case scenario, which is very important. But, Wells Fargo doesn't have all the international potential correlation and contagion effects as some of the other banks. [Note: As of December 31, 2011, Selected American Shares has a small 0.2% position in JPMorgan Chase. See our August 2011 fund update for more detail about the managers' rationale for nearly eliminating this position.]

English: Yes. I mean, you can never say never. I would say that of those three, JPMorgan would certainly be the one that we'd be most interested in. They have the most dependable franchise and the most trustworthy management. JPMorgan would certainly be a stock that we could own. But right now, I would say no for Citigroup or Bank of America.

Q: Is JPMorgan more analyzable than other big banks?

English: From what we've learned about JPMorgan, yes. I would say that they're more transparent. When you look at the risk of their book, I think it's laid out better than Bank of America's or Citigroup's and their track record is much better. Track record means a lot in the banking industry and the insurance industry. You can create earnings with a pen. You can go years and years carrying a bad asset and nobody knows it. Then you get the big bath, which is kind of the nature of Citigroup and Bank of America, but much less so with JPMorgan. Through the work that we've done on Bank of New York, [we learned that] JPMorgan has a significant fee-based business in custody and in some of the books of business that Bank of New York has that we like. Now, they're not particularly profitable today, given the Bernanke situation, but they're potentially extremely profitable. We like that aspect of it.

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Q: Are there any scenarios you could think of that could wipe out an equity holding in banks, and how likely are these scenarios?

Feinberg: For Wells Fargo, the big issue is home-equity lending. They still have about $90 billion to $100 billion of home-equity loans. I think 35% or so are really first mortgages, meaning there is no other mortgage ahead of it. Then, maybe 25% or 30% are second mortgages behind a Wells Fargo first [mortgage], which is important, because that sort of gives you control. But, the 35% or so that are second mortgages behind some other bank's first mortgage are in a precarious situation, potentially. Those loans are paying, but [the concerns are] whether people would continue to pay them even when they are underwater and about how banks have reserved for these home-equity loans.

I think the real risk is not so much that the equity goes to zero, it's that the equity gets depleted and they have to raise capital, [diluting shareholders significantly]. That's what Citi had to do. AIG is really the best example. The government just took it over, so the shareholders are down 97%. And, it wasn't the same deal Citi or Bank of America got. It could be something from regulators or it just could be the fact that they have to issue all the stock down 50%.

English: If you go back to the 2008/2009 crisis, equity holders should have been wiped out. They should have dug into the fixed-income investors next. I mean, we didn't let the system work! We could easily see how you could wipe out the equity of the banking industry in a crisis. That's what should happen. I think that you have to allow failure. What we have right now is just this long, drawn-out zombie environment. It's the same thing that happened over in Japan. Unless you let these things clear naturally, you get a long, long period before you get a real recovery. So, we're five years into it already since the peak of the real estate market, and it probably is going to be another five years. It could have been over a lot quicker and it would've sent a great message to the marketplace, and to investors who take the risk. They're the first line of defense here, not the taxpayer. I think the system survives bankruptcy. That's how the whole system was built—to have bankruptcies and to have restructuring.

Q: Excluding banking, what are some of the business models you like in the financial sector?

Davis: We have increased our holdings in the property/casualty sector. We own property casualty companies through Berkshire, but we also own them through Loews (because of CNA). We have the Transatlantic and Alleghany, which are merging together. But, I would say that's a group where we know there's excess capacity. We know there's asset pressure. But, we think that a lot of companies should, over time, have double-digit returns on equity that are trading at 80% of book. We think that book value is really the liquidating value of the business, and it puts a zero value on the renewal rates [for a] business that we think actually does have a value. We're not making any predictions about a turn in the property casualty pricing cycle, but the one prediction we will make is that there will be one someday. It does seem that prices are acting a little bit better. To us, that will be excess return.

English: In the insurance marketplace, we want to be able to co-underwrite those books. We want to be able to see what those risks are, and make a determination as to whether they're adequately reserved. We can't do that in most of the reinsurance businesses. The only reason we own Berkshire is they have such a stout balance sheet and such a good long-term record. We're willing to give them a pass on that, but we

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really don't like reinsurance. There are so many unknowns in that business. Over the 25 years that I've looked at it, it's like buying a potential land mine. The industry is just fraught with risk. These risks are sold down the line, repackaged, and sold to the next guy, then repackaged and sold to the next guy. Oftentimes, you really don't know what risk you own. You think you do, but you don't. It's only in the fullness of time that you realize you're holding a time bomb. We've seen so many reinsurance companies go bust over the years, and others just struggle. The worst part about it is when there are a lot of catastrophes, when you have a market that's reporting a lot of losses and, all of a sudden, there's a feeling that the market's going to harden. All of a sudden, you get tons of new capacity. You get book after book after book of new entities starting in Bermuda just when you're really ready to make money. It's a business that just has an inherent low return and it's completely unpredictable. So it's a lethal combination for us.

But basic insurance underwriting, where we can see what's being done, we think there's a good return on that business. We like the brokers in that business as well, because we don't have the underwriting risk, but we have the underlying growth of a rebound in the economy and we play that cycle through the brokers. We certainly like the investment management business for some of the reasons that are obvious—you have high margins and low leverage. You can see into the portfolio, so you can make a determination as to whether you want to be in those risks or not.

We have [liked] the financial processors. We don't have too many today but, periodically, they come up. We find those more interesting than the pure financial companies—think of FiServ and SunGard Data and Jack Henry, those types of companies. There are elements of Bank of New York that fit into that category. We like those types of businesses. It gives you a call-option on growth in financial services, but it does it with a recurring-revenue, high-ROIC business model.

Thank you for your time and insights.

—CB&T Investment Team (3/2012)