

That we are overdone with banking institutions which have banished the precious metals and substituted a more fluctuating and unsafe medium, that these have withdrawn capital from useful improvements and employments to nourish idleness, that the wars of the world have swollen our commerce beyond the wholesome limits of exchanging our own productions for our own wants, and that, for the emolument of a small proportion of our society who prefer these demoralizing pursuits to labors useful to the whole, the peace of the whole is endangered and all our present difficulties produced, are evils more easily to be deplored than remedied.

–Thomas Jefferson, 1810

January 2012: A Word on Banking

By John Goltermann, CFA, CPA

Throughout his public life, Thomas Jefferson cautioned on the widespread damage that banking run amok can do. Jefferson was notably skeptical of the banking business and worried that the government could be subverted to banks' interests if their activities were allowed to proliferate unchecked.

Were he alive today, Jefferson would be dismayed by the evolution of banking, the state of excessive debt in the United States and the incestuous relationship between Washington and Wall Street. This relationship is the handiwork of collaborative political and financial industry interests – interests that, faced with a lack of real wage growth and anemic economic prospects, led to policies, procedures and products that incentivized banks to lend to poor credits. Washington's and Wall Street's parallel motivations of power and money fed off each other to create a system that saddled society with cleaning up the wreckage.

Lending to poor credits had the exact *opposite* of the intended consequence: instead of helping the less fortunate to improve their circumstances, it helped precipitate a de-urbanization that left entire neighborhoods abandoned and looted. The path to unwinding this mess will take time. The U.S. must first establish a clearer, more stable, rules-based financial system – one without Wall Street's usurpation of politicians. The way forward will likely bring more volatility in certain asset prices, more uncertainty over who will pay the most and, of course, much histrionics in the press coverage of it all.

Equity investors are tiring of the stock market and its tether to perceptions on the health of U.S. and European banks. Despite the strong economic performance of many industrial and infrastructure investments, cheap stocks continue to get cheaper based on banks' fragility that in turn causes broad deleveraging, mass sector rotations and fear. A market platform that allows for billions of dollars to be moved with a keystroke amplifies the size of daily moves.

Now that it is a new year and we're past the usual market gyrations that occur from tax-loss selling, window-dressing and portfolio re-allocations, it is back to business. The euro-crisis still commands center stage in the press with its numerous recent downgrades of sovereign credits, but the same long-term dynamics that we've spoken about for years are still in play: excessive leverage, political interference, slow domestic growth yet improving basic living standards abroad. Perhaps the fundamentals of investing will be embraced again and value will be recognized where it exists.

While the last few commentaries have focused on the macro-economic and capital market issues that have weighed on investors' minds, here we want to explore the state of banking, because, after all, it is the behavior of many banks (in concert with their political friends in Washington) that in large part can be blamed for the current economic malaise, macro-uncertainty and political dysfunction.

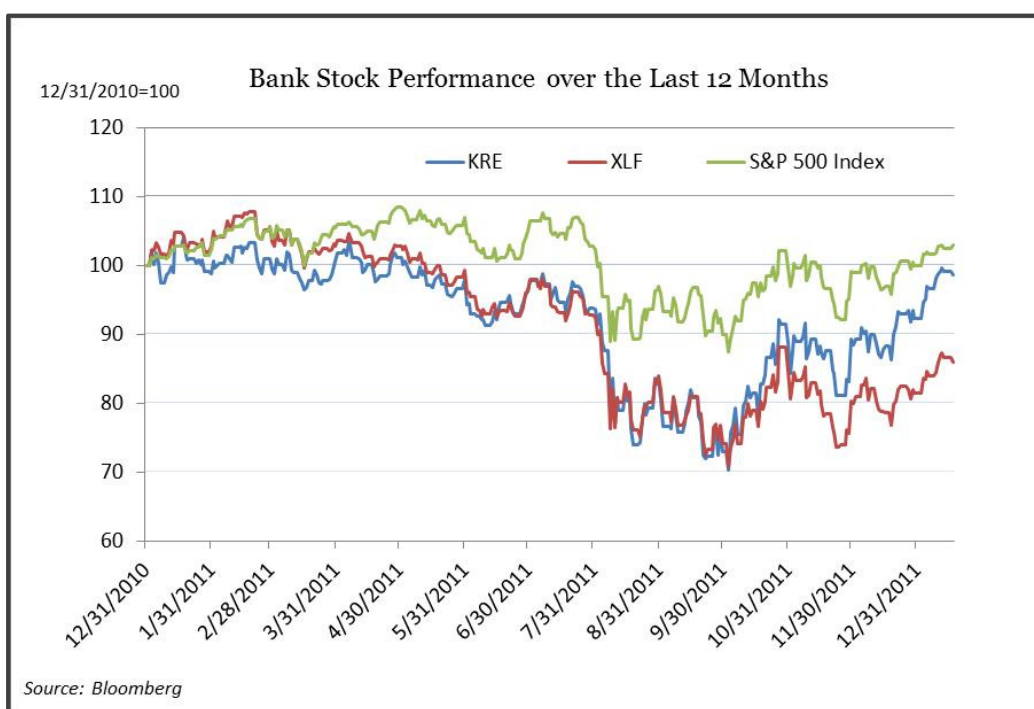
Had governments not intervened to save banks during the 2008 crash with massive bailouts, free lending from the Fed, outright purchases of toxic loan bundles and a huge increase in deposit guarantees, the last four years would likely have been defined by a crash of 1929 proportions – one in which most American and European banks would have been wiped out. The bailouts presented an excellent opportunity to cull the herd or break up the Too-Big-to-Fail banks, to reform banking practices, to jail (and otherwise punish) miscreants, to replace inept boards of directors and to generally reboot the business of banking. It was an opportunity to recast banks in their more traditional role of lending with sensible and thorough due diligence – and with less leverage and risk. Unfortunately, this did not happen.

Instead, Washington green-lighted an epic papering-over of a major deterioration in banks' financial condition by forcing the Financial Accounting Standards Board to change their guidelines on FAS 157 – the pronouncement that specifies how illiquid investment values (such as loan packages) are to be reported. Instead of mandating independent appraisals, managements can now "use their judgment" to value these securities. In other words, they have wide discretion to create and use models to support whatever figures they want.

The argument for relaxing FAS 157 is that without changing this rule, many banks would have failed because they would have been forced to raise capital at a time when there was a dearth of it, and they wouldn't have been able to raise enough to fill the holes blown in their balance sheets

by their management teams. While this may be true, do the means justify the end? The rule change sacrificed an investor's ability to analyze the true financial condition of the capital seeker (financial institution). This means that *any* capital raised by these banks must now come from reticent speculators, sector-rotators and short-termers...not from long-term investors that are a much more stable source. FASB's agreement to change the rule now also means that, unfortunately, accounting standards are subject to Congressional scrutiny, and those standards that are deemed to be politically or systemically adverse can be modified or repealed.

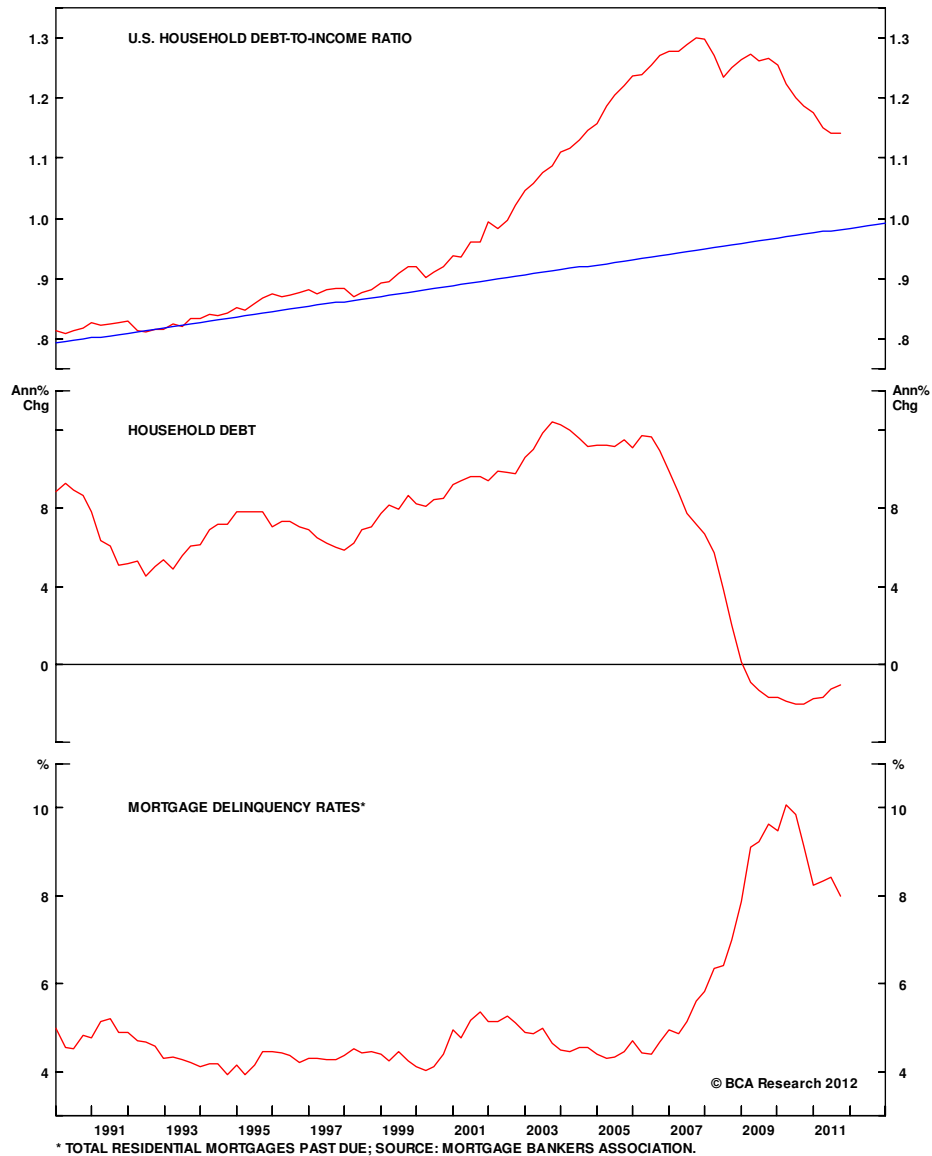
What was the end result of the Washington-sponsored bailout money plus the *now*-allowable obfuscation of financial reporting? The top five banks in the United States grabbed more market share, increasing their percentage of total U.S. banking assets from 28% in 2000 to 47% in 2010.¹ It pays to have powerful friends!

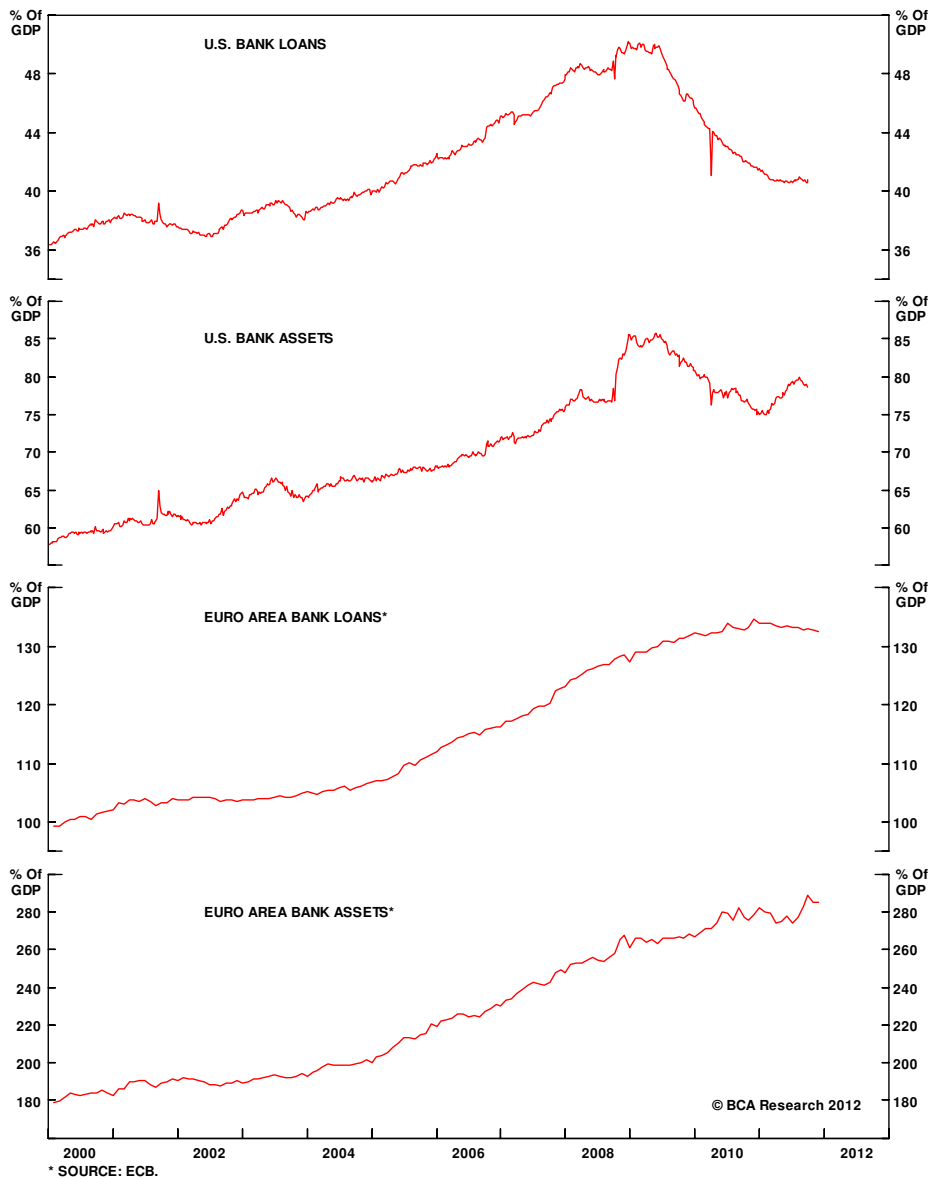


With the exception of the investment banks, it appears that some banks have made financial progress since 2008 (see chart above). Their stock prices have continued to underperform the S&P, but at least they have outperformed Wall Street. Banks in general have languished, of course, because they couldn't lay off all their suspect real estate exposure onto Wall Street banks, Fannie Mae, Freddie Mac or the Federal Home Loan Bank – which are all now wards of the state. (As an aside, taxpayers have absorbed \$200 billion of losses and counting on Fannie and Freddie.)

¹ Source: Federal Reserve Bank of Kansas City

As shown in the charts on this and the following page, progress has been made on overall debt reduction, but there is still work to do. Another headwind for regional and small banks is commercial real estate. They are saddled with piles of debt backed by vacant stores, shuttered warehouses, empty office buildings, etc. This is why we continue to be generally concerned about U.S. banks and continue to shy away from investing in their securities. Of course, any hint of pro-growth policies coming out of Washington could go a long way towards helping non-performing real estate begin to perform.





Wall Street Reforms Needed

A major problem with Wall Street banks is the complete opacity in the composition, quality and leverage of their balance sheets. Another is that they are incentivized to act badly given previous taxpayer support granted by Washington. This is why their bonds trade at big discounts to comparably rated securities, and their stocks trade at a discount to net asset value.

One would assume that if a bank's share price and debt instruments were selling at sizable discounts, that its executives would not be getting bonuses that year. In a capitalist system, theoretically, executive pay is for value-creating performance of a kind that drives share prices to

large premiums over book value. But the bosses of the TBTF banks, who are long on greed and short on shame, eschew the capitalist principles that they find inconvenient for setting their own compensation.

There are myriad examples of this, but Citigroup typifies many of the practices that have not been voluntarily reformed at investment banks. Citigroup's CEO, Vikram Pandit, who received a \$48 million signing bonus (not to mention a \$164 million payout on top of it from the sale of his interest in his hedge fund to Citigroup) shortly before presiding over a 95% drop in Citigroup's stock price, was reinstated to full bonus eligibility last year and received a retention package worth \$23.2 million in 2011. Note: Citigroup had a good year last year on a *relative* basis as its stock price only dropped from \$51.26 to \$28.74.

To be fair to Citigroup's board of directors, at least Chuck Prince, who bulked up Citigroup's balance sheet with toxic, non-liquid assets using off-balance-sheet liabilities, *only* received a \$10.4 million bonus when he left in November 2007. Perhaps Vikram's full bonus reinstatement was because Citigroup's management found a bullet-proof way to get its stock price up in 2011 – a 1:10 reverse split that boosted the stock from \$4 to \$40. Now that's one way to do it!

The rage that found expression in the Tea Party and in Occupy Wall Street, two unlikely allies, came not only from the bailouts, but also from the eight-digit compensation packages paid out to executives who destroyed shareholder value and caused the near-implosion of the financial system writ large.

That the bonuses would continue to be in the tens of millions of dollars per year is especially remarkable after Wall Street's attempt at a real-life adaptation of Mary Shelley's *Frankenstein* where amoral geniuses blended small quantities of healthy financial tissue with large quantities of necrotic flesh in an effort to create financial super-specimens. Like Victor Frankenstein, these scientists became obsessed first with creating their monsters, then thought about the consequences later – the major consequence being that the monster would keep coming back to haunt them. In contrast with the grotesqueness of the Frankenstein monster, the laboratory-concocted financial specimens sported a reassuring cloak of AAA ratings – ratings that had previously been mostly reserved for well-run governments fully backed by the taxation systems of strong economies.

Why do I devote such focus on these mega-banks? The unfortunate reality is that, because of banks' market share in the economy, investors in general need these banks to be part of the solution to economic growth; we need them to behave with the discipline and humility that will instill confidence in their long-term viability. If they can be viewed as something *better* than taxpayer-sponsored, fee-generating machines that skim money from the speculative activities of others in order to enrich insiders and key employees, more confidence in our financial system will

return. Based on their demonstrated expertise in building shareholder value, we would not be surprised to find out that one or more of them are worried about their own Europe exposure, which explains the Fed's swap lines and other U.S.-based support for the fragile European banking system. For this reason and the reasons mentioned earlier, we are reluctant to invest in the big banks, but will monitor their stock price movements as they can be a signal of better, or tougher, times ahead.

In my view, last year's bank stock weakness reflected an increasing fear that prompted market participants to liquidate cyclical stocks, even those that were cheap and had solid long-term businesses. Since much of markets' moves are related to short-term projections, it makes sense in hindsight that this would be the case; but we certainly did not anticipate that other investors would adjust their portfolios to the large degree that they did.

Current Outlook and Positioning

From a big picture standpoint, not much has changed from a year ago. We still have three billion new entrants into the global labor pool in China, India and Latin America, with improving skills, increasing productivity and better intellectual property. This puts downward pressure on wages in the U.S. and Europe, but upward pressure on food and energy prices as these emerging economies transition to being more demand-based. This likely means slow or negative real growth and a rising cost of living in the U.S. and Europe for the foreseeable future, especially as the Chinese relax their yuan peg.

Our investment response is multi-pronged: 1) get the asset allocation right so that each client can manage market volatility, both emotionally and financially; 2) recognize the role of currencies and a global, concurrent, central-bank-led pursuit of "beggar thy neighbor" policies in managing them and invest/hedge accordingly; 3) examine trade-down plays, i.e., Costco, as declining *real* discretionary income in the U.S. is a strong likelihood for reasons enumerated before; 4) build exposure to the higher prices of certain commodities over the long term, which result from governments monetizing bad debts, scarcities increasing and standards of living improvement in the emerging markets; 5) build exposure to infrastructure-related investments – infrastructure investment is independent of the business and credit cycles; and 6) stay focused and monitor events for change on political, credit market and economic fronts.

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