

SPECIAL

E-Memo

TO: CLIENTS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss
Date: July 23, 2008
Subject: Tom Brown asks: Is it a Bottom in Financial Stocks?

Is it a Bottom in Financial Stocks?

Our short answer: yes

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One never knows until long after the fact, of course, when stock prices reach the exact top or bottom of a given cycle. And, besides, trying to pick precise tops and bottoms always turns out to be a pointless, unprofitable game. So don't even try.

Have I hedged myself sufficiently? Good. For, as it happens, I believe July 15, 2008 will turn out to be as good a date as any to mark the end of the long, painful bear market financial stocks have endured for the past 18 months. And more to the point, it marks the beginning of the *greatest financial stock bull market in our lifetime, one that will be much broader than the bull market that began in 1990.*

Caution! The observation above is offered to investors only. If you can't stand the idea of seeing another, say, 20% on the downside, please stop reading at once and head back to CNBC.com. If you measure your investment horizon in weeks or months, please, for your own good and sanity, leave this site pronto.

But if you understand what drives stock prices, and have an investment time horizon of at least one year, feel free to keep reading. And if you are a patient value investor, get out your highlighter and get ready to buy stocks.

I believe the current valuations of scores—even hundreds—of financial companies are wildly out of whack with the companies' long-term earnings potential. The companies are extraordinarily undervalued, in my view. In the vast majority of cases, I can get comfortable with their potential future credit losses and (in the cases where they're needed) the possibility of future, dilutive capital issuance.

With the gap between current market values and business values so wide, investors shouldn't even worry too much whether July 15th was indeed rock bottom for the stocks. *The margin for error today is so wide that any investor with at least a one-year horizon and a little analytical ability can pick huge winners.* We wouldn't buy across the board, but the vast majority of the depressed financial stocks will survive, recover, and deliver high investment returns from these levels.

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Why July 15 was Capitulation Day

Financial services investors had a lot to deal with last week. Do you recall? On Monday, they grappled with news that regulators had closed IndyMac the previous Friday. It was the third-largest bank failure ever. Also over the weekend came word that the Treasury Department and Fed had drawn up plans to stabilize Fannie Mae and Freddie Mac.

It was momentous-sounding news—but, if you think about it, not necessarily negative. IndyMac's failure couldn't have been a surprise, thanks to Sen. Schumer. And the prospect of a stabilized Fannie and Freddie should have been seen as a positive, both for the economy and other financials. Even so, investor angst rose and, on Monday, the XLF, an index of large-cap financial stocks, dropped by 5%, closing on its low.

Then came Tuesday, and already-nervous investors were hit with the following news items before the market opened:

1. GM suspends its dividend.
2. Retail sales for June come in lower than expected.
3. The dollar hits a record low against the euro.
4. June PPI comes in higher than expected.
5. Long lines ring IndyMac branches, as depositors of the failed bank seek access to their funds.
6. A popular bear, Meredith Whitney of Oppenheimer, lowers her rating on Wachovia to "underperform," citing the company's bleak prospects.
7. Bloomberg runs a story reporting that private equity investor TPG has already seen its spring investment in Washington Mutual cut by two-thirds.
8. CNBC interviews its new favorite investment guru, Bill Ackman, about his plan to "save" Fannie and Freddie. Ackman, who admits he just shorted both companies, describes a plan that would wipe out common shareholders of both companies.

In all, it was pretty scary stuff to deal with in a highly fragile market.

Activity During July 15

So what happened next? The following events on the 15th stand out as being especially significant, in my view:

1. **Financial stocks decline dramatically in the first 45 minutes of trading.** It was an across-the-board collapse. Citigroup, which closed at \$16.40 on Monday night, traded as low as \$14.02, a decline of 15%. Wachovia, the subject of Whitney's downgrade, was off by 20%.

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2. **The VIX hits 30.82 in the first 45 minutes.** The VIX is of course everyone's favorite measure of investor nervousness. Recent readings above 30 have signaled a peaking in the level of panic.
3. **First Horizon's stock rises at the open, despite all the bad news.** First Horizon, a heavily shorted banking company, had moved up its earnings release to Tuesday from Thursday after seeing its stock decline 25% Monday over fears about its survivability. After the company released an earnings report that showed it was far from spinning out of control, its stock opened up 5%--*despite* the panic in the financial sector. The stock closed up 14% on the day.
4. **Financial stocks stage a dramatic turnaround in the morning before closing lower on the day.** For example, the XLF, after its initial 5% decline, rose 9% from the trough, but still closed down 3% on the day.
5. **An incredible volume of shares trades.** On July 15th, 469 million shares of the XLF traded, eclipsing its previous one-day volume record, set the prior Friday, by 150 million shares. This record would fall two days later when 528 million shares traded. July 15th will be a day to remember!

Why July 15, 2008 Will Be Remembered As the Bottom

Beyond the highly volatile, dramatic trading patterns that happened on the 15th, conditions for a turn seem to be in place that will be familiar to anyone who's lived through a market extreme before.

1. **Long-term company valuations are *extremely* depressed.** Before trading began on July 15th, many financial services companies were trading at valuations wildly out of line with their long-term earnings prospects--simply because of excessive investor fear. The fear has come about from the very real credit problems that have developed over the last 18 months, and the unrealistic expectation that they will persist indefinitely into the future.

With the banks stocks off by 50% in the last three months alone, investors seem to have been stunned into inaction, while bearish momentum investors have piled on their shorts. Rational analysis about companies' long-term prospects has given way to the simplistic notion that chargeoffs must go higher, so stock prices must go lower. As a result, many financial stocks are significantly undervalued relative to their long-term earnings potential.

2. **Bearish analysts have devised new methodologies to justify current or lower stock prices.** Just as tech analysts rolled out new valuation methodologies to justify sky-high stock prices at the peak of the tech bubble in 1998 and 1999, bearish financial services analysts have developed new

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"methods" to "value" financial stocks to avoid recommending them now.

They are nothing if not resourceful. One analyst, for example, estimates a bank's entire future losses, deducts that number from tangible book value, then assumes the bank raises additional capital at current (highly dilutive) prices. Then he assumes the stock should trade at or below that estimate of pro forma, adjusted tangible book value. Potential book value growth from future earnings? A return to normal valuation? That counts for nothing.

Clearly all the analyst wants to do is come up with as low a number as he can, whether it makes sense or not, in order to justify his bearish position. This isn't "conservative" analysis. It's poor analysis.

- 3. New investment gurus are worshiped, while previous ones are said to have lost their touch.** Remember back during the tech boom, when great investors such as Warren Buffett, George Vanderheiden, and Julian Robertson were suddenly seen as dinosaurs because they refused to participate in the mania? It was a new era, and those old guys "didn't get it." Today Bill Miller, Marty Whitman, Wally Weitz, and others are being criticized not just for their refusal to short the financials, but for actually *owning* them. People say that "this time it's different," and that these erstwhile investment legends suddenly don't know what they are doing. I'll bet on the legends.

So who are the new media darlings? One is Bill Ackman, a man with a mixed track record at best. To show how crazy the current environment is, he shorts Fannie and Freddie on Thursday and Friday and then calls CNBC to tell them he has a plan to "save" the companies, which (what a coincidence!) involves a complete wipeout of common shareholders. And CNBC takes him seriously! *None* of the financial journalists who interviewed him on July 15th questioned his true motivation.

Then there's Meredith Whitney, who last year raced to become the most bearish bank analyst on Wall Street. She published her latest report last week and held a conference call with investors on July 15th. Her new angle: stay away from bank stocks because future credit losses will be much higher than they think. Why? Well, Meredith discovered that the home-price futures that trade on the Chicago Merc are forecasting greater price declines than the banks expect. The futures market on which Whitney hangs her entire report has an open interest of all of 435 contracts, with a notional value of—are you ready?—\$17 million. Since when do equity analysts rely on new, illiquid market pricing to do their forecasting?

- 4. Fears about dividend cuts and new, dilutive capital raised are excessive.** Here's a shocker: an investment bank specializing in the banking industry issues a report that predicts that . . . banks

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will have to raise a lot of new capital! KBW, the investment bank in question, is not famous for having an especially sturdy Chinese wall separating its research and corporate finance efforts. In any event, it says 180 banks need to raise \$30 billion in equity, based on its own stressed-earnings scenario. Do you think the report was perhaps a little self-serving?

In fact, I think second quarter earnings results are providing encouraging signs that the credit problems won't turn out to be as great as widely feared, that not as much dilutive capital will need to be raised, and that fewer companies will have to cut their dividends. For example, despite its strong recent bounce and better-than-expected second quarter earnings, Bank of America stock still yields 8.7%.

5. **Second quarter earnings reports are so far encouraging.** While commercial banks have mostly been the ones to report earnings so far, their reports have been encouraging with respect to credit quality. I'm specifically referring to changes in delinquency rates, slowing inflow of new non-accruing loans, and the lack of meaningful increases in criticized assets.

Even the accounting for credit problems is improving, as companies have tightened up on the classification of loans 90 days past due but not on non-accrual. Banks seem quick to take writedowns on non-accrual loans and are aggressively building reserves.

It is by no means clear sailing from here. Even so, the stocks are significantly undervalued under all but the harshest economic scenario. The evidence from second quarter earnings to date is that that scenario won't come close to happening.

First Horizon: A Great Example of Undervaluation

To see the mismatch between a company's valuation and the outlook for its underlying business, let's look at one bank that's been a favorite of the shorts: First Horizon. The company's stock has been battered over worries regarding its mortgage subsidiary and its large home equity and residential construction loan portfolios. Over the last year First Horizon has fallen from \$35 to as low as \$4.50 last Monday.

As I mentioned, the company last week moved up its earnings release because of the pounding the stock took on the 14th. It reported a second quarter loss of 11 cents per share. Beneath the headline number, though, underlying trends in credit quality were encouraging, which made us increasingly comfortable with management's worst-case loss estimates.

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In a nutshell, here's why buying First Horizon at the current \$8.25 stock price looks like a great investment opportunity to us.

- Credit is stabilizing.
- Capital has already been raised and cash dividend eliminated.
- The stock trades at 66% of its tangible book value per share.
- The stock trades at 2 times pre-tax, pre-provision earnings.
- The stock trades at 4 times our estimate of "normalized" earnings per share.

I wish I could make this more complicated, but I can't. The stock sells at an extreme valuation, even as signs emerge that its credit issues are manageable. And not only is capital sufficient, we believe it will prove to be excessive. Given all this, it's not hard to see First Horizon's stock price rising into the low 20s over the next 18 months. That's a three-bagger on the upside without survival risk. I like that tradeoff. (And, yes, in case you're wondering, we own First Horizon.)

First Horizon is just one of many, many financial services companies that I believe are ridiculously undervalued. No, not all the performance indicators at these companies are headed in the right direction yet. But the signs of a turn are pretty clear. *Investors* know how expensive it can be to wait for an "all-clear" sign. I'm not waiting for an all-clear. Could the stocks' prices correct after their strong advance? You bet! But for investors, the time to buy is now.

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