But…………

Riders on the storm

November 21, 2012: 11:25 AM ET

Wells Fargo avoided the reckless tactics of other banks and quietly built a powerhouse in the West. Now its takeover of Wachovia makes it a national force, but how much toxic waste is aboard the stagecoach?

By Adam Lashinsky

This story is from the May 4, 2009 issue of Fortune. *It is the full text of an article excerpted in* Tap Dancing to Work: Warren Buffett on Practically Everything, 1966-2012, *a* Fortune *Magazine book, collected and expanded by Carol Loomis.*

PHOTO: ROBYN TWOMEY

Pardners: Stumpf, with strongbox, took over as CEO last year, succeeding Kovacevich, who built the empire and plans to retire as chairman.

FORTUNE -- Dick Kovacevich ought to be happy. The sun is shining in San Francisco on an early April morning, shares of Wells Fargo, where Kovacevich is chairman of the board, have almost doubled in a month, and Wells appears to have survived the worst of the banking crisis with its reputation intact (so far). Yet Kovacevich, at 65 a pugnacious and famously outspoken banker, is peeved, to put it mildly. He's miffed at short-sellers who have hammered Wells Fargo as if it were one of those troubled-asset repositories. He bemoans the media for failing to recognize Wells Fargo's achievements. Most of all, he's seething with anger at Washington for all sorts of bad decisions, from making a show of big-bank stress tests (which he has publicly called "asinine") to giving him exactly one hour to accept a $25 billion investment in October from the controversial Troubled Asset Relief Program, or TARP. "I'm willing to say the emperor has no clothes," Kovacevich says, his face reddening as he loudly denounces the government's behavior. "The facts are so obvious," he booms. "It's just not credible that you would give $25 billion to someone who didn't need it."

In the financial crisis, however, the facts often support clashing theories. Wells Fargo (WFC) is emerging as one of the best banking franchises in the country. Thanks to its core strength and acquisition of rival Wachovia, Wells for the first time is a coast-to-coast player, comparing, often favorably, with J.P. Morgan Chase (JPM) and Bank of America (BAC). But the $12.5 billion acquisition of troubled Wachovia has provoked serious and legitimate doubts as to whether Wells needs even more capital on top of the TARP money it received. Its stock price has skidded, along with that of every other big bank, on fears of everything from an inadequate capital cushion and hidden credit risks to the possibility of banking nationalization.

The Wachovia purchase has injected a note of tension into the story of Wells Fargo, which in every other way has been a rare upbeat tale amid the banking wreckage. Simplicity explains its success. Among the big banks, Wells has one of the lowest cost of funds, a steady stream of nonbanking revenue (from businesses like insurance brokering and mortgage-loan servicing), and, most of all, a history of avoiding the rest of the industry's dumbest mistakes. It never got into the type of structured investment vehicles, or SIVs, that tripped up Citigroup (C), for example. (Says John Stumpf, Wells Fargo's CEO, who succeeded Kovacevich in that position last year: "When I first heard about an SIV, I thought it was a four-wheel-drive vehicle. Honestly.") Despite having a major position in mortgage underwriting, Wells refused to join the crowd in offering no-documentation (or "liar") loans and option ARMs that let borrowers determine how much they'd pay each month. (Wachovia's 2006 purchase of Golden West Financial, which popularized option ARMs with its infamous Pick-A-Payment program, crippled Wachovia and led to its purchase by Wells.) **As a result, Wells lost significant market share in the mortgage business from 2003 to 2007 -- a setback that is now a sign of virtue.** Such discipline makes Wells consistently more profitable than its peers, an enviable place to be -- provided its uncharacteristic fling with risk by buying Wachovia doesn't prove its undoing.

PHOTO: JASON E. MICZEK/BLOOMBERG/GETTY

A higher profile: Wells CEO Stumpf (above left), presents a token to Wachovia's Robert Steel last October.

Warren Buffett delights in telling an anecdote about Wells' banking relationship with his own company, Berkshire Hathaway (BRKA). In 2001, when Berkshire and a partner bought Finova, a bankrupt lender, it solicited banks to become part of a loan syndicate. "Wells wasn't interested," says Buffett, who is Wells' largest shareholder, with 315 million shares, or a 7.4% stake. The others offered to lend Berkshire money at the ultralow rate of 0.2 percentage points above its cost, a loss leader intended to win follow-on investment-banking business from Berkshire. Not Wells. "I got a big kick out of that because that was exactly how they should think," says Buffett, with a hearty guffaw.

The tale speaks volumes about why, despite its size -- second by market capitalization ($83 billion) and deposits ($800 billion), and fourth-ranked in terms of assets ($1.3 trillion) -- Wells Fargo is so often overlooked. The tall and imposing Kovacevich, a pro-baseball prospect in his youth, gets downright defensive, blaming "you guys in the media" for not paying attention to banks "west of the Hudson." But that doesn't really explain the bank's low profile. In fact, Wells is less known because it concentrates on bread-and-butter banking rather than sexier activities like investment banking and trading for its own account. "The real insight you get about a banker is how they bank," says Buffett. "Their speeches don't make any difference. It's what they do and what they don't do. And what Wells didn't do is what defines its greatness."

Wells, more than any big bank, makes its money by lending. It focuses on consumers and midsize businesses, which tend to be more profitable customers than *Fortune* 1,000 corporations that can raise money from many sources. And Wells relentlessly cross-sells everything, including credit cards and mortgages (to consumers) and treasury-management services and insurance (to businesses). Wells persuades each retail customer to buy an average of almost six products, roughly twice the level of a decade ago. Business customers average almost eight products per customer.

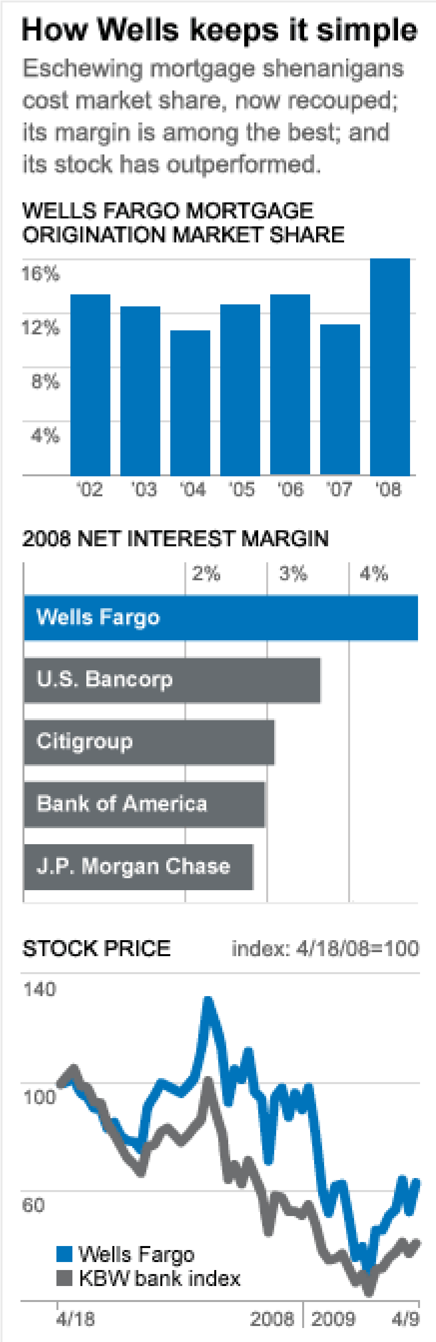
PHOTO: JUSTIN SULLIVAN/GETTY IMAGES

The combined bank will have more than 12,000 ATMs.

This type of banking pays in two ways: Retail customers, once satisfactorily hooked, tend not to take their business elsewhere unless they relocate. Similarly, smaller companies tend to rely on their bankers for services that big corporations more often buy from specific consultants. A case in point is Morning Star Packing, a tomato processor in California's Central Valley with about $700 million in annual sales. Chris Rufer, its owner, has banked with Wells since 1983. His company has no board of directors and doesn't hire fancy-pants management consultants. That makes him appreciate Wells all the more, especially a Harvard MBA named Ken McCorkle, who runs the Wells agriculture industries group. "They've got people who are competent to understand our business," says Rufer.

Wells is consciously contrarian. About a decade ago it bought a large business-insurance brokerage, and since then it has been busy snapping up smaller agencies to complement its offering. (As a broker, Wells doesn't underwrite insurance, so it isn't a source of risk. Instead, insurance is simply another product Wells offers its business customers.) In 2008, when Wells' overall revenues grew 6%, to almost $42 billion, its insurance line jumped 20%, to $1.8 billion, making it the fourth-largest business-insurance broker in the country. One important component of the uptick was a thriving crop-insurance business that spiked with the rise in commodity prices.

Where Wells has truly distinguished (and differentiated) itself is in mortgages. Run out of offices in Des Moines -- far from the California headquarters of the industry's two biggest blowups, Countrywide Financial and Golden West -- the business began in 1906 as Iowa Securities Corp. Though a national force, the mortgage arm began losing ground to competitors in 2003 because it stayed away from the industry's riskiest products. It also alienated brokers by calling attention to what Wells saw as abusive practices. Cara Heiden, co-head of the mortgage operation, says Wells' computer programs began flagging subprime mortgage applications from customers who could qualify for prime-priced loans. (Subprime loans carry higher rates and therefore pay higher fees to brokers.) "We would send the borrowers a prime-priced product -- and cc the broker," she says. Predictably, Wells lost share, though its business continued to grow. Wells also dramatically cut back its roster of brokers, from a high of more than 25,000 in 2006 to just 8,100 today. Last year Wells regained the No. 1 position in the market for U.S. mortgage originations, with a 16% share. That should grow with the purchase of Wachovia, whose share, excluding the Pick-A-Payment business, was about 3%.



SOURCES: INSIDE MORTGAGE FINANCE; KEEFE BRUYETTE & WOODS; BLOOMBERG
FORTUNE GRAPHIC

In the banking industry, loyal customers translate into cheap sources of capital. A family with a mortgage, a checking account, and a brokerage account is less likely to leave to chase higher CD rates, for example. As a result, Wells excels at making money the old-fashioned way, on the spread between deposit and lending rates. (Think: Borrow cheap, lend dear.) Its average cost of funds in the fourth quarter was just over 1.5%, compared with an industry average of 2.1%. "If you're the low-cost producer in any business -- and money is your raw material in banking -- you've got a hell of an edge," says Buffett, who caused a 20%-plus jump in Wells shares in March simply by expressing confidence in the bank on TV. "If you have a half-point edge -- and they get that edge now on the Wachovia assets as well -- half a point on $1 trillion is $5 billion a year."

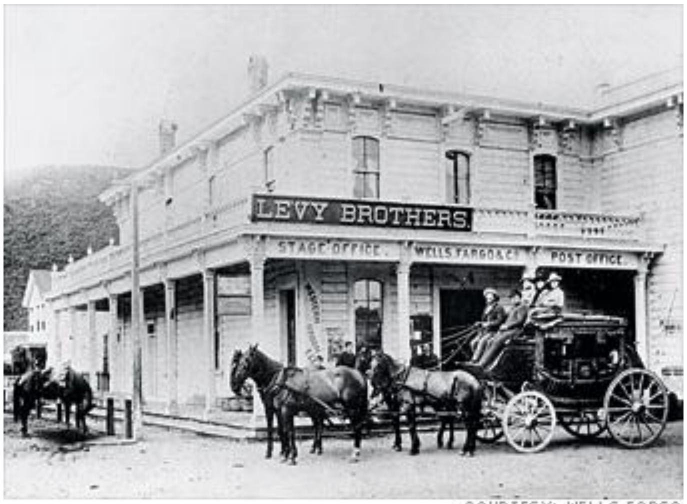
Whether Wachovia's assets give Wells a critical edge or irreparably dull its momentum has been the biggest question mark surrounding the San Francisco bank for months. It is fitting that an epic acquisition would define

Wells Fargo's future, because it has been a bank-buying machine for years. Founded in 1852, the modern Wells became takeover bait itself. In 1998, Norwest, the Minneapolis bank then headed by Kovacevich, bought Wells Fargo, assumed its name, and moved the headquarters to San Francisco. Kovacevich had once been a hotshot banker at Citibank, but after CEO John Reed passed him over for a key promotion, he moved to Norwest in 1986. The Minnesota bank bought more than 150 community banks, often in bad economic periods, in places like Colorado, Texas, and Arizona. Despite persistent speculation that he would pounce again after buying Wells, Kovacevich didn't make another big move, preferring to solidify his position west of the Mississippi.

Then came the crisis of last autumn, beginning with the collapse of Lehman Brothers and the government-arranged sales of Washington Mutual and Merrill Lynch. On the last weekend of September the FDIC conducted a forced auction for Wachovia, with Citigroup and Wells Fargo as the two bidders. Citi won that round, agreeing to pay $2 billion for Wachovia's banking franchise, with the government guaranteeing a portion of the losses Citi would assume. Wells thought it could pay more, so after two days, with Kovacevich in Manhattan negotiating with regulators and Stumpf in San Francisco leading a team of 300 numbers crunchers, Wells offered to pay $15.4 billion for all of Wachovia -- without any help from Washington. Or so they thought.

Two weeks later, on Oct. 13, Kovacevich was sitting at a long conference table with eight other bank chiefs in Washington, listening to Treasury Secretary Hank Paulson tell them why they should take the government's money. Kovacevich says he protested, telling Paulson that compelling banks to accept TARP funds would lead to unintended consequences. It would erode confidence in the banking sector by making investors question the healthiest banks rather than instilling confidence in the neediest. Other industries undoubtedly would come to expect a bailout themselves. Still, Kovacevich took the money.

His displeasure leaked to the public, but what hasn't been reported is exactly how Paulson flipped the seasoned banker so quickly. In what an observer in the room describes as a "true Godfather moment," Paulson told all the assembled bankers, "Your regulator is sitting right there" -- actually the industry's two biggest overlords were in attendance: John Dugan, comptroller of the currency, and FDIC chairwoman Sheila Bair -- "and you're going to get a call tomorrow telling you you're undercapitalized and that you won't be able to raise money in the private markets." For Kovacevich this broadside was the horse's head on his pillow. He and his bank were in an unfamiliar position of vulnerability. Wells had just agreed to buy Wachovia, a bank it had coveted for years, and it needed the government's approval -- and, critically, the ability to raise money -- to complete the deal. Reflecting on the episode with righteous indignation, Kovacevich points out that each of his warnings to Paulson was later validated. Yet he turns sheepish in explaining his decision. "You want to do what your country and your regulators want," he says quietly in his office, decorated with miniature replicas of Wells Fargo's iconic stagecoaches. "There was no ambiguity," he says, as to what was expected of him.



COURTESY: WELLS FARGO

Gold rush: Founded in 1852 by Henry Wells and William Fargo, the company built offices all over the West -- like this one in Pescadero, Calif.

As the autumn progressed, the markets had begun to lump Wells Fargo in with every other big bank, and justifiably so. Investors were concerned that Wachovia's problems were so severe that Wells had bitten off more than it could chew. Wells Fargo set out to raise equity to finance the deal, but potential investors wanted to know why, if the government had just injected $25 billion into Wells, it needed additional money to buy Wachovia. It was a good question. Kovacevich says the bank's regulators specifically asked Wells to go ahead with the fundraising so that Wells would have a bigger capital cushion. At $12.6 billion, Wells raised more money than any non-IPO on record, but less than the maximum $20 billion target it had set. The Wachovia deal closed on the last day of the year (for $12.5 billion, nearly $3 billion less than the original offer price), and Wells that day wrote down $37 billion of a $94 billion Wachovia loan portfolio.

The large write-down, a banking term referring to the reduction of the value of an asset, removed a significant amount of risk from Wells Fargo's balance sheet -- but not enough for Wells' critics. The write-down had the effect of weakening what had become a key ratio investors had begun to watch called tangible common equity, or TCE. It measures a bank's capital cushion without giving it any credit for ephemeral assets like goodwill. As a result of the deal, Wells had a TCE ratio of 2.7%, less than the 3% that many banking investors consider a bare minimum for healthy banks.

As recently as October, Wells had claimed it didn't need additional capital. Yet here it was, a recipient of the government's money and still undercapitalized by one important measure. The new burden of TARP began to chafe in February, when word got out that Wells was hosting its annual "recognition event" for top-performing mortgage brokers in Las Vegas. A populist rage ensued at the boondoggle by a TARP recipient, and Wells promptly canceled the event. CEO Stumpf wrote a defiant letter to employees, which Wells published as an ad in national newspapers, saying that the real victims of the controversy were the hospitality-industry workers of Las Vegas. If Wells hadn't been on the map before, its gestures of rebellion were starting to draw attention and curiosity: Just who are these cowboys?

By late February the heat grew more substantial. The Treasury Department announced it would conduct confidential stress tests of the country's 19 biggest banks to understand how well they could survive an even deeper recession. (Kovacevich earned headlines weeks later for his remarks calling the move "asinine" on the grounds that regulators routinely conduct stress tests at banks.) Suddenly no bank was considered safe. Wells shares briefly fell below $8 -- from more than $40 in the fall -- and after relatively healthy competitors J.P. Morgan, U.S. Bank (USB), and PNC Financial (PNC) all cut their dividends, Wells did too, by 85%.

The bank integrator: Callahan is in charge of merging Wells and Wachovia. "No time for partying," she says. "No spa, no golf, no cream cheese on the bagels."

The dividend cut exposed a chink in Wells Fargo's armor. It had said repeatedly that it needed no new capital. But if that were true, it wouldn't have needed to slice the payout. By way of explanation, Stumpf, a 55-year-old Minnesotan who hails from a farming family and bakes bread as a hobby, says, "We're going through unprecedented times, and more capital is better than less capital." It's a fair argument but not entirely persuasive. The dividend cut, announced in early March, should generate capital at a rate of $5 billion per year. Add that savings, the private fundraising of almost $13 billion, and the $25 billion in TARP money, and Wells will have accumulated $43 billion since October (not including earnings), about $23 billion more than it had said it needed to fund the Wachovia acquisition. Yet it still isn't in a position to repay the Treasury. Investors worry that Wells has kept certain Wachovia portfolios off the combined bank's balance sheet. Frederick Cannon, an analyst with banking specialist Keefe Bruyette & Woods, highlights two potential problems, a $355 billion batch of commercial mortgages and $137 billion of exposure to credit derivatives. Were those assets added to Wells' balance sheet, the bank's need for capital would be even greater, says Cannon, who in a worst-case scenario can see Wells needing to raise another $25 billion. "They've built a great franchise," he says. "Wouldn't it be great if they just had a bigger cushion of capital?"

On April 9, Wells at least temporarily quieted its critics by pre-announcing first-quarter earnings of $3 billion, twice what Wall Street had expected, but without providing much in the way of operating metrics. Wells said the Wachovia integration was ahead of schedule, that it had funded $100 billion in mortgages, and that its tangible common equity ratio had hit 3.1%. The stock price surged 32%, to almost $20, and Wells Fargo single-handedly sparked a 246-point rally in the Dow. For a day, at least, the markets were paying attention to a suddenly very large bank with headquarters west of the Hudson River.

There would be far fewer questions about Wells Fargo, of course, if it had simply ceded Wachovia to Citi. But for all the factors Wells Fargo can't control, successfully integrating Wachovia is one it can. The monumental task has been entrusted to executive vice president Patricia Callahan, a 31-year Wells veteran who has worked at the bank (including a San Francisco predecessor) her entire career -- in commercial lending, in compliance, and as head of human resources. The project will be grueling, creating a combined entity out of a network of 11,000 branches, 70 million customers, 12,000-plus ATMs, and 281,000 employees. Fortunately for Callahan, she recently completed a six-month sabbatical and says she returned refreshed. "This integration is complicated in terms of timing, systems, training, and logistics," she says. Through her efforts, Wells plans to slice $5 billion in annual operating costs from the combined banks' budgets by 2011, a 10% reduction.

Wells has a playbook in these matters, namely Norwest's three-year, painstaking acquisition of Wells Fargo a decade ago. Callahan says 21 business-unit and staff-function integration teams, and many more sub-teams, are at work mapping a calendar they intend to complete by the end of April. An all-hands integration team meeting in San Francisco in March drew 150 attendees in person and another 200 on the phone and went from 7 a.m. to 6 p.m. "No time for partying," she says, in a nod to the still-hurt feelings over the canceled "recognition event" in February. "No spa, no golf, no cream cheese on the bagels."

Though Wells and Wachovia operated largely in different parts of the country, overlap is a cost-saving opportunity. Each had significant operations in five states: Colorado, Arizona, Nevada, California, and Texas. Callahan says those states will get the makeover treatment first, with the bank converting no more than a few hundred branches at a time. The plan is to rebrand everything Wells Fargo; the Wachovia name is destined for the trash heap of bank brands.

In most areas Wells considers itself Wachovia's better. For example, Wells ATMs have capabilities that Wachovia's don't, like envelope-free deposits that customers love. So every Wachovia ATM will be upgraded. Stumpf ticks off the opportunities Wells will have with Wachovia's customer base, which before the merger was similar in size to Wells Fargo's. "We have twice the number of online customers that they do," he says, online banking representing a significant cost savings. "Thirty-eight percent of our customers carry our credit card. Eleven percent of theirs carry their credit card. Our debit-card penetration is much higher here. Our mortgage penetration is much higher here." And so on.

Wachovia had some advantages over Wells. Its wealth-management and brokerage arms are stronger, featuring a highly skilled sales force in the image of Merrill Lynch's. That unit, the remnant of Wachovia's acquisition of brokerage A.G. Edwards, will survive and be run by a Wachovia executive, David Carroll, the sole officer from the vanquished company to join the Wells executive management team. Wachovia also ranks higher than Wells on customer-satisfaction surveys, and some Wells customers chafe at constantly being asked to buy additional products. Wells says it will try to learn from Wachovia in this regard: for example, by adopting Wachovia's customer-tracking software.

At least one Wells Fargo "team member," as the San Francisco bank refers to its employees, certainly won't be around to see the Wachovia integration through. Kovacevich says he'll retire for good "by year-endish or early next year-ish," and maybe sooner. Though Wells doesn't provide golden parachutes, Kovacevich already has done just fine. His pension is worth $30 million, and in 2006 and 2007 he exercised and sold stock options worth $77 million. He insists he'll take no other banking job, including the CEO position at Citigroup, which passed him over all those years ago. "I would never compete with Wells Fargo," says Kovacevich. "This has been my life." For years it was accepted in banking circles that Kovacevich coveted the Citi job, but that was before the bank's financial and leadership challenges. Then again, his demurral is far more believable today, considering that when Citi completes an exchange offer it has announced, the U.S. government could own as much as 36% of the company. Kovacevich working for the government officials he has so loudly criticized is a tough one to imagine.

END

The Brooklyn Investor

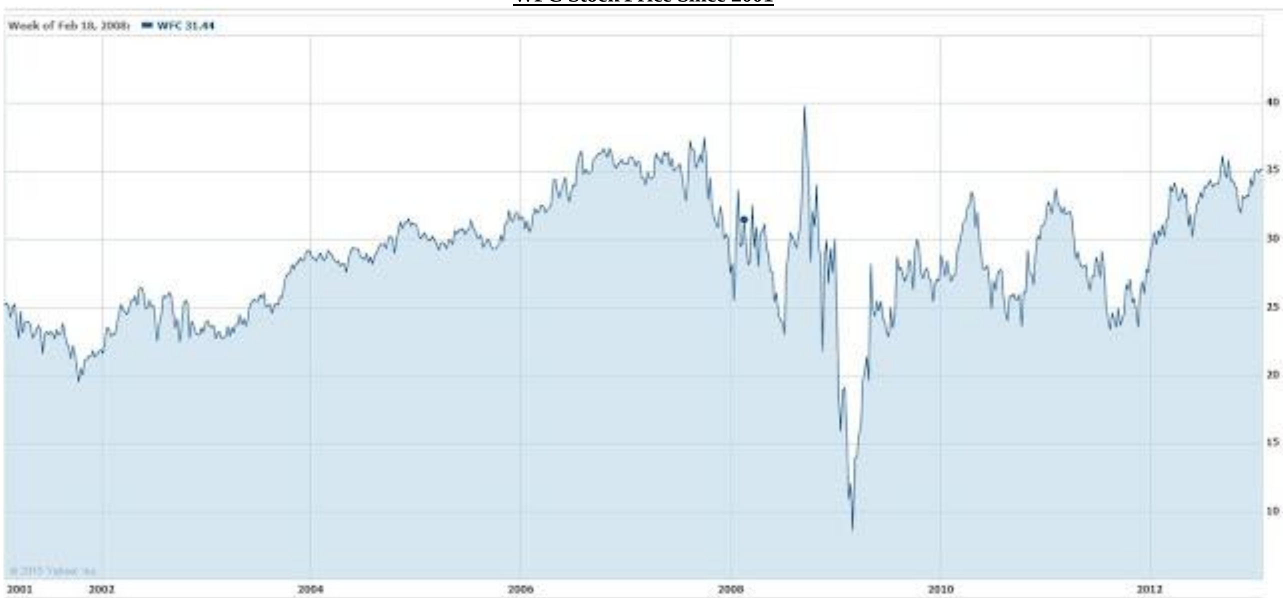
Tuesday, January 29, 2013

Mr. Market versus Mr. Buffett

Not to beat a dead horse, but this Wells Fargo situation kept lingering in my mind so I thought I'd make this followup post. It is well understood by value investors but since I have a pretty wide readership in terms of stock market experience, I thought I'd post this because there is something to be learned from thinking about WFC, Buffett and how the market works.

What Mr. Market Sees

WFC Stock Price Since 2001



- Mr. Market sees a volatile stock. WFC went from $40/share to below $10/share during the crisis; way too volatile. A 75% decline is just unacceptable to own for a conservative portfolio. Of course, Mr. Market is the cause of this volatility. The volatility just illustrates the manic-depressive nature of the stock market.
- Not only is the stock very volatile, but it has gone nowhere for a long time.
- Mr. Market views banks as too risky not only because of the stock price volatility and gone nowhere-ness, but because **it's too complex, opaque and leveraged**. Mr. Market prefers the 'safety' of bonds, the 'safety' and non-correlatedness of private equity funds, hedge funds and other alternative investments as the stock market has done nothing in the past decade and is just way too risky.
- Mr. Market sees no future for the banking industry; higher capital requirements and heavier, more extensive regulation makes the future of the industry bleak. Also, the size of some of the bigger banks (like WFC) makes it unlikely it can grow more in the future. Skeptics point to the lame top line growth at many financials in recent years.
- Mr. Market reads newspaper and magazine articles that predict a repeat of the most recent crisis; people tend to spend a lot of time fighting the last war. **There is a weird obsession in the media with large, 'evil' banks who have gotten away with murder unpunished.**

What Mr. Buffett Sees

- Mr. Buffett does not care about stock price movements. He only cares about the health of the underlying business. He believes that stock prices will generally reflect the value of the business *over time*, but not every single day, month or even year. Stock prices can be misvalued for long periods of time. This does not bother Mr. Buffett in the least. If a stock goes down 80%, he doesn't care as long as the intrinsic value of the business hasn't gone down 80%. He worries about *permanent* loss of capital, but never worries about *temporary* loss of capital due to stock market volatility (if you want to avoid this *temporary* loss of capital, as in anything else, there will be a cost!).
- Mr. Buffett is in no rush to get rich (or richer, I should say). Much of the folly in financial markets comes from the **need for people to get rich quickly**. In fact, I've had people tell me that they speculate in foreign currencies at 100-1 leverage because they said they are not rich enough to be able to buy stocks and wait for them to go up over the long term like Mr. Buffett, nor are they smart enough to be able to pick stocks like Mr. Buffett. Another favorite is that they simply don't have the time to be reading annual reports. Of course, it never occurs to them that if they are not smart enough to pick stocks, who says they are as smart as Soros to be able to make money trading FX? Needless to say, I've never heard of a good outcome from people who have said this to me.

- Going back to bullet point one, Mr. Buffett only cares about the underlying fundamentals of the business. While Mr. Market focuses on the stock price movements in the above chart, Mr. Buffett focuses on the following table which shows how WFC has grown BPS over time (including dividends):

	WFC BPS growth (including dividends)
2002	+19.1%
2003	+21.4%
2004	+19.2%
2005	+17.5%
2006	+21.0%
2007	+15.1%
2008	+20.8%
2009	+27.1%
2010	+13.2%
2011	+11.7%
2012	+15.8%

- The above table is just astonishing. Show this to someone without telling them what it is. Ask them, would they invest in a fund like this? If this wasn't a major bank, people would be all over this thing. How many funds or hedge funds have this kind of track record? This is what Mr. Buffett looks at; not stock price history (except when buying shares, price is important so as not to overpay).
- Having looked at this, it solves another puzzle. For years, Berkshire Hathaway (BRK) fans have been calling for share repurchases and dividends and things like that. People seem to be very upset that Mr. Buffett hasn't bought back more shares. Now we can see why he hasn't been buying back more shares; he sees something *better*. Here is the above table with BRK's own BPS growth right next to it (be sure to be seated when viewing this table, or hold onto something):

	WFC	**BRK**
2002	+19.1%	+10.0%
2003	+21.4%	+21.0%
2004	+19.2%	+10.5%
2005	+17.5%	+6.4%
2006	+21.0%	+18.4%
2007	+15.1%	+11.0%
2008	+20.8%	-9.6%
2009	+27.1%	+19.8%
2010	+13.2%	+13.0%
2011	+11.7%	+4.6%
2012	+15.8%	?
5 year avg:	**+17.6%**	**+7.3%**
10 year avg:	**+18.2%**	**+10.2%**

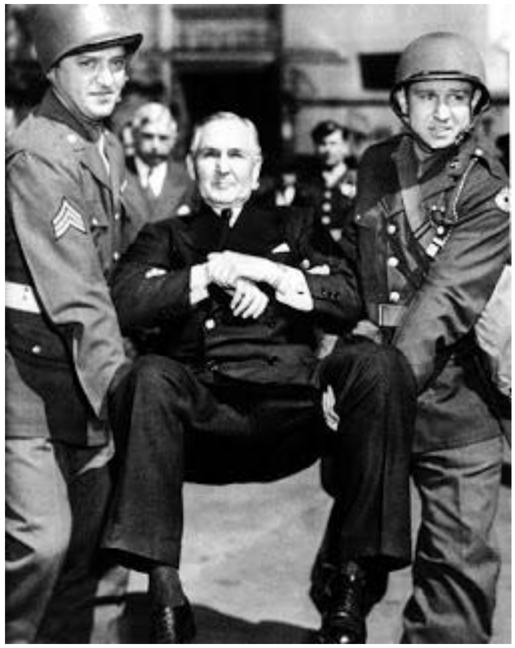
OK, so I cheated as we don't have BRK's 2012 BPS yet. BRK five and ten year periods are through 2011. But I don't think it makes a difference in the story it tells. WFC's performance is just amazing compared to BRK. It has beaten BRK in every single year, and in most years by a pretty wide margin. This is unbelievable. And this is the decade that included the financial crisis?! You'da thunk BRK woulda done better than a major bank with tons of mortgages.

Go through the table again, starting at the top and slowly look at both figures, year by year, and imagine the headlines in those years. You would never have guessed the outcome of these two entities in any of these years.

There is a tremendous bias against banks these days, but if there wasn't, Mr. Buffett's thinking should be as clear as anything. You would be insane to call for him to be buying back BRK stock when he can be buying WFC at an attractice price.

In fact, if Mr. Buffett starts to buy back large amounts of stock when WFC is trading at these levels, this is what I think should happen:

Imagine Mr. Buffett's Face in this Picture



I am not tech savvy enough to cut and paste Mr. Buffett's face over Sewell Avery's. But yes, if he chooses to buy back BRK stock (right column) over WFC shares (the left column in above table), that would mean he has finally lost his marbles. Call in the troops. Take him away!

Back to Bullet Points

- While Mr. Market seeks comfort in the safety of bonds and alternative investments that promise to make money year in and year out no matter the environment, Mr. Buffett understands that this is nonsense. Bonds are bubbled up right now and have a lot of risk, and again, the history of folly in the investment world is often caused by not only the need to get rich quick, but to get low-risk returns. The promise of consistent profitability, low volatitily and non-correlation manufactured by financial engineering often delivers on the promise for a time until it blows up. The cure is often worse than the disease. Mr. Buffett understands this very well.
- While Mr. Market sees the end of banking as a profitable business, Mr. Buffett disagrees. He concedes that the days of 20x leverage and 30% ROE are over, but it's still a very good, profitable business. We don't need another bubble for banking to be a good business (again, look at the above table!).
- Mr. Buffett doesn't worry about top-line growth as he sees that it will come when the economy recovers. He sees a housing recovery as the key to lower unemployment and a stronger economy and he sees that coming, eventually. He has tried to time the recovery before and got it wrong, but he still has no doubt it will come.
- Even if the top line doesn't grow too much, Mr. Buffett understands that if you have a profitable business model and excess capital, it can be returned via stock repurchases. He doesn't need a company to grow; intrinsic value per share of a business can grow a lot without a lot of top line growth. If you earn 15% ROE and see no top-line growth and just repurchase shares with the profits and you do so at book value, you can grow your BPS 15% (well, even if you don't repurchase shares BPS will grow 15%, but then ROE will go down next year if you can't deploy that 15% at 15% ROE). If you pay 2x book, you still grow BPS at 7.5% (yes, it would be dilutive to BPS, but can still grow it. If my other other post is right, then you can still grow intrinsic value per share even if you buy stock above BPS). If management is competent, businesses can be managed to enhance per share intrinsic value. There are a lot of value creating levers.
- Mr. Buffett is not worried about the riskiness of banks. He has been investing in banks for decades and knows banking better than most bankers. A few obsessed journalists writing scary stories about how opaque the banks are (who probably have never even read a 10-k all the way through) is not a concern. Some of these writers have only lived through one cycle. Buffett (and to a lesser extent, Dimon) have seen many cycles and understands that it's the same thing over and over.
- He agrees with Dimon who pointed out when people were skeptical of the Fed stress tests that they have actually just lived through a real-life stress test and passed with flying colors. WFC too has passed this real-life stress test amazingly well. People will argue that that is thanks to TARP, but even the Geithner hating, big bank busting Sheila Bair has said that WFC and JPM are well managed and weren't in trouble and didn't need TARP. It's amazing that these banks did so well in a 100-year crisis; particularly when WFC was one of the biggest mortgage lenders and the bust centered on residential real estate.
- Mr. Buffett finds it ironic that people say banks were bailed out by the government (so won't invest in them) but are fine with investing in hedge funds, private equity funds etc. When they bailed out the big banks, they bailed out the financial system. If the financial system failed, many hedge funds and other investors would have lost a ton of money; look what happened to prime brokerage clients at Lehman, clients at MF Global etc.
- Mr. Buffett finds it ironic that banks are accused of being opaque when they consistently file hundreds of pages of material with the SEC every year, and yet people invest in hedge funds with nowhere near the disclosure. Dimon said the other day something like, "We file a 400 page 10-K every year, what do you want to know?" Perhaps if Madoff had to file with the SEC (in similar detail), people wouldn't have lost money. Mr. Buffett has been reading annual reports for more than half a century. I doubt most journalists have even read one all the way through. (I don't blame them; much of the low quality in journalism is due to deadlines and quotas; I don't think any journalist is any dumber than anyone else. It's just that if you are an investor thinking about spending billions of dollars to buy into a stock, you are going to do a little bit more work on it than someone who needs to get an article to his editor by 2:00 pm Thursday. This is why TV journalism can be even flakier; their deadlines may be shorter and they need to fill airtime with stuff. And you just can't put out a lot of high quality stuff all day. I am always shocked at how little financial journalists seem to know and understand even when many have more years in the business than me. Are they that stupid? I realized it's not that at all. They don't have a deep understanding because they never dig that deep as they don't have the time. They only have to dig deep enough to get the story out. Then it's on to the next story. That's why my sister understands more about business than some of these so-called veteran journalists; it's not the journalist's job to understand. It's their job to sell newspapers, magazines, and fill air

time) Oftentimes, you're better off going with the guy with decades of experience and someone who probably has read every single filing for hundreds of companies going back decades over some guy rushing out an article for a deadline where the 'story' is already predetermined (and probably the headline too).

Anyway, this can go on and on so I'll stop here. I thought it would be an interesting post for some (but same old, same old for us value people).

Monday, January 28, 2013

Wells Fargo is Cheap!

OK, so in my last post I commented that WFC is a great bank but is fully valued. This thought stuck to my mind over the weekend. Sometimes when I write something (whether blog or email), what I write bounces around in my head and I have second thoughts about it long after I hit the "send" or "publish" button.

I was wondering, is it really fully valued? If it is fully valued, then why does Buffett keep buying WFC stock? He has been buying even before the crisis when the storm clouds were very visible, and even now after financial stocks have rallied a lot.

Why I Said It's Fully Valued
First, let's just look at why I think (or thought) WFC is fully valued. This valuation approach is the same as how people look at other banks like JPM, BAC and others.

But anyway, here it goes. Below is the ROA and ROE of WFC since 1997.

	ROA	ROE
1997	1.37%	12.81%
1998	1.04%	9.86%
1999	1.85%	17.66%
2000	1.81%	18.53%
2001	1.40%	14.94%
2002	1.77%	19.60%
2003	1.64%	19.36%
2004	1.71%	19.56%
2005	1.72%	19.57%
2006	1.73%	19.52%
2007	1.55%	17.12%
2008	0.44%	4.79%
2009	0.97%	9.88%
2010	1.01%	10.33%
2011	1.25%	11.93%
2012	**1.41%**	**12.95%**

Here are the averages for the various time periods:

	ROA	ROE
Since 1997	1.4%	15.0%
Last 10 years	1.3%	14.5%
Last 5 years	1.0%	10.0%

WFC has a decent, consistent record. One way to look at it is that WFC in normal times can earn 1.5% ROA and a 15% ROE or something like that. With a 15% ROE, WFC can easily be worth 1.5x book value.

As of the end of 2012, BPS of WFC was **$27.64**/share. 1.5x that is **$41.46**/share. At $35/share, WFC seems to be trading at a 15% or so discount to what it's worth; not so exciting. Of course, it is still a good, solid holding. If it's worth 1.5x book and the book keeps growing, WFC can obviously still be a great stock to own.

So one way to look at it is that although it may not be trading at a discount to what we think it's worth, it's still a good investment due to future growth.

Just for fun, let's just take a look at what BPS has done over time at WFC. If we are going to pay close to 1.5x book and our returns will come from growth in BPS instead of a valuation adjustment, we have to see what BPS has done and think about what it might be able to do in the future.

	BPS	DPS
2001	$8.00	$0.50
2002	$8.98	$0.55
2003	$10.15	$0.75
2004	$11.17	$0.93
2005	$12.12	$1.00
2006	$13.58	$1.08
2007	$14.45	$1.18
2008	$16.15	$1.30
2009	$20.03	$0.49
2010	$22.49	$0.20
2011	$24.64	$0.48
2012	**$27.64**	**$0.88**

So looking at it this way, it's pretty incredible. Look at how much BPS has grown over time, and through the crisis too.

Here are the growth rates of BPS over five and ten year periods:

	BPS growth per year
Five years	+13.9%
Ten years	+11.9%

But BPS growth excludes dividends, so let's add that back and see what BPS growth + dividends would have been:

	BPS growth w/dividends
Five years	+18.2%
Ten years	+17.6%

That's pretty stunning. This kind of record shows that BPS/share for WFC is a no-brainer long. This BPS growth did get a one time bump up from the Wachovia merger, but it's still pretty impressive.

1.5x book value implies a 12%-ish sort of return. Of course, with 1.5x book as a terminal value, then the return can be 18% over time if they do just as well in the future as they have done in the recent past. You can say that the last five - ten years was an outlier bad period for financials (but others would argue that the 2005-2007 was outlier good years so it balances out).

In any case, either way, 15% ROE seems achievable and the same would apply here. You can say 15% ROE = 10% return at 1.5x book, or if you see 1.5x as fair value going forward with no change in terminal value for the foreseeable future, you can expect a 15% return over time even at 1.5x book.

I tend to see things the first way; 15% ROE at 1.5x book = 10% expected return. This may or may not make sense according to what you think. But that's just the way I look at things and I think it's the *conservative* way to look at it.

Back to Buffett

So let's get back to Buffett. He has been buying WFC even at non-distressed prices. Why? I remember when someone asked Buffett about banks and book value and Buffett said that book value is not important. He does advocate ROE as an important measure of a business, but oddly enough, when discussing WFC during the crisis, he said it's not important. At the time, he said the cost of capital was the most important thing; the one with the lowest cost will win.

(I think he does look at BPS and it is important to him, but maybe other factors are more important depending on the situation).

The other piece of the puzzle is Buffett's goal of earning a pretax 10% return. This is what Buffett has been quoted as saying. At last year's annual meeting I think he mentioned that he likes to pay 9-10x pretax earnings for a good business.

I think a while ago, Munger also mentioned using WFC as a benchmark to evaluate potential investments; if it's not better than WFC, why bother buying something else? I may be wrong, but I do think that within the context of that discussion he mentioned that WFC can earn 10% pretax return on the then current price.

So that also confirms that this is the valuation benchmark at Berkshire.

Now you see where this is going. For financials, the Street often uses 10% as the discount rate; if a financial company can only earn 5% ROE, then it's only worth 50% of book. If it can earn 20% ROE (consistently), then it's worth 2x book etc...

Using Buffett's valuation measure, you will get a different result.

So let's go back to WFC with this new valuation tool (well, it's not new but...).

WFC at 10x Pretax Earnings

In the year just ended, WFC had pretax earnings of $27.1 billion (I added the $9.1 billion in income tax expense to the $18 billion net to common; the pretax income on the income statement includes minority interest and dividends payable to preferreds so $27.1 billion gives us pretax income to common shareholders).

Using Buffett's measure, WFC is worth $271 billion. With 5.266 billion shares outstanding, that comes to **$51.46/share**.

WFC is trading at $35/share now so that's a 70 cent dollar right there. *That's 50% upside, not in two years, but NOW!*

And keep in mind, this is not intrinsic value or fair value or anything like that; *it's a price that Buffett would happily pay for the shares.* He says he wants to pay 10x pretax earnings, right? He needs to earn a 10% pretax return, right? Well, $51.46/share gives you that.

But, but, but...

This price would come to close to 2x book. What kind of nonsense is that? How can a financial stock trade at 2x book in this post-crisis, new, new normal world? I know. It sounds ridiculous. If I said this out loud in a bar downtown near the New York Stock Exchange, I would get laughed right out of the room.

But I'm just putting things together. There is nothing new here. I am not making big projections, assuming anything incredible or anything. I just took some facts that are out there and just slapped them together and that's what you get.

Also, I know most people still fear banks and think another crisis is around the corner. Well, if you are a WFC shareholder and see what it did during the last crisis, then you should be praying for another crisis!

Rich Get Richer During Bad Times (or Big Get Bigger)

I will put another piece of the puzzle here. At one of the recent annual meetings, Munger talked about how Rockefeller, Carnegie and others got rich. They got rich during the bad times. When bad times hit, these guys grew by buying up the distressed competitors. This is how it's always been, so it's silly to worry about bad times. Munger said that if you don't get it, you are an idiot (maybe he had a more elegant way of saying it, but I do remember he said it strongly).

I think this was in a context of answering a question about some fear about the future (of the macro outlook, stock market etc...).

And if you look at the above BPS growth of WFC, you can see how exactly right Munger is. WFC shareholders should wish for a financial crisis every year! (WFC grew BPS including dividends at +18%/year in the last five years; it grew BPS + dividends 27% in 2009. How many hedge funds (who are supposed to make money in volatile markets) made a 27% or better return in 2009? And of those that did, how many have not given it back?).

Buying distressed asset funds / private equity funds / hedge funds to take advantage of volatility and bad times may not be a bad idea, but here is a company that is is doing it, right in front of our eyes. They do very well in good times and even better in bad times. Why do people bother looking for someone to hedge their 'deltas', give them non-correlated, leveraged alphas and things like that? Sometimes (or most of the time), the medicine kills the patient; this need to reduce or eliminate perceived risk ends up killing them. And sometimes the answers are just so simple.

Anyway, others will point to the one time-ness of the accelerated BPS gains by WFC because of the crisis, but you can't have it both ways. You can't argue that WFC is no good because another crisis is around the corner, and then worry that the BPS gains in the recent past is one-off so not indicative.

Conclusion

So there you have it. The greatest investor of all time will be buying WFC all the way up to **$50/share** (and this will keep going up over time). And for those worried about another financial crisis around the corner, you want to own a company that will benefit from it. *If you buy WFC and study it's history, you will just start praying for another crisis instead of worrying about it*.

What's not to like?

I get it.

(No, I do not own WFC at this time. I have owned it in the past and may in the future. By using the above measure, maybe JPM / BAC / GS are even cheaper than I think they are.)

Thursday, January 24, 2013

Financials Still Look Good: Part 2

Bank of America (BAC)

BAC announced earnings too, and things there are looking interesting. Like other banks, there is a problem with NIM pressure. But the investment bank / brokerage business seems to have done really well.

I won't go into any details here, but I just want to jot down what I was looking at. First of all, the valuation play for BAC is similar to JPM even though I have very different views on the management of each. I have a very high regard for JPM management, but only so-so for BAC. These post-crisis / scandal CEO appointments tend not to work out too well over time and I can't get over the fact that this may be true in the case of BAC too.

I know Buffett has endorsed current BAC management, but I think he really sees the value of the franchise; his ownership of BAC was a bet on the cheap valuation of BAC and their competitive position and not necessarily the current management (even though he has explicitly said that the current CEO is doing the right things).

This is the part that is interesting. In post-crisis / scandal situations, the right thing is usually pretty straight forward. It's not easy, necessarily, but the job is to clean up the mess made by the previous management. It doesn't take a lot of creativity, vision, or leadership skills or anything like that. In a turnaround situation, survival is the priority so you don't need a visionary, charismatic leader.

Chuck Prince and Martin Sullivan looked good too, initially for a few years, when they were just cleaning up. But they proved to be horrible CEOs beyond that. I have no proof that Moynihan is any better or worse than Prince or Sullivan at this point.

Anyway, the valuation play here is simply that BAC is worth book value, or 1.5x tangible book value. I think Moynihan has stated that BAC can earn at least 15% return on tangible book in normal times (when the current high cost of dealing with the mortgage mess settles down).

At 2012 year-end, the BPS for BAC were:

BPS:	**$20.24**
tangible BPS:	**$13.36**

It just so happens that BPS is 1.5x tangible BPS, so we get the same valuation target using 1x BPS or 1.5x tangible BPS. With the stock price at around $11.50, there is still pretty substantial upside.

I've looked at this from the point of view the sum of the parts, so let's take a look at the old Merrill. It turns out that the old Merrill is doing very well. Here are the returns on average equity (ROAE) and returns on average economic capital (ROAEC, basically return on average tangible equity) of the three business segments that is the old Merrill (even though global banking now includes more than just the former investment banking business).

Global Wealth and Investment Management

	2011	2012
ROAE	9.9%	12.53%
ROAEC	30.52%	25.46%

Global Banking

	2011	2012
ROAE	12.76%	12.47%
ROAEC	26.59%	27.21%

Global Markets

	2011	2012
ROAE	4.99%	19.19%
ROAEC	6.34%	26.14%

The returns for Global Markets exclude DVA and UK tax adjustments. So the old Merrill is looking pretty good. Combined, I think the total ROAE comes to 14.3% which is very good.

I think it is safe to say that the these three segments, or what we call the old Merrill is worth book value.

So let's see how this breaks out. Using average balance sheet figures for 4Q12, the allocation of equity and tangible equity to the old Merrill (combined above three segments) were as follows:

Total equity: $82.1 billion
Total economic capital: $42.2 billion

There are 10.8 billion shares outstanding so BPS of the old Merrill is **$7.60**/BAC share. Tangible book is **$3.91**/BAC share.

BAC is now trading at around $11.50, so the old BAC (pre-Merrill) is trading at $3.90/share (keep in mind, though, that some of the old BAC is now in the old Merrill; Global Banking, for example). What do you get for $3.90/share?

For BAC as a whole, the common equity and tangible equity were:

Common equity: $218 billion
Tangible equity: $144 billion

Stripping out the old Merrill from above, you get:

Old BAC:
Common equity: $136 billion
Tangible equity: $102 billion

On a per share basis, that comes to **$12.59**/share in BPS and **$9.44**/share in tangible BPS for the old BAC (or the post-Merrill-spinoff-BAC).

So you are getting $12.59/share in book and $9.44/share in tangible book for $3.90/share! That's a 60% discount to tangible book and 70% discount to BPS.

Pretty stunning when you look at it that way.

If the post-spin BAC is worth tangible book value and the Merrill is worth BPS, then the fair value of BAC is:

Merrill value (@BPS):	$7.60/share
BAC ex-Merrill value at tangible book:	$9.44/share
Total value:	**$17.04/share**

That's 50% higher than the current price of around $11.50/share. This is less than the $20/share book value for the current BAC as we don't give credit to the goodwill in the non-Merrill portion of BAC (which is goodwill from the Countrywide deal and maybe some others). So it can be seen as conservative.

Goldman Sachs (GS)

Goldman also reported and had a double digit ROE. It reported 16.5% annualized ROE for the 4Q2012 and 10.7% for the full year.

BPS of GS at year-end was **$144.67**/share and tangible BPS was **$134.06**/share.

So GS is now trading right around at book value per share ($144.50). There has been concern that investment banks are dead, that new regulations will make it impossible for GS to make high returns again etc.

But I disagree with that. I do feel that GS will be able to generate good returns over time. Just as a review, here is a long term look at the growth of BPS at GS:

	BPS
1999	20.94
2000	32.18
2001	36.33
2002	38.69
2003	43.6
2004	50.77
2005	57.02
2006	72.62
2007	90.43
2008	98.68
2009	117.48
2010	128.72
2011	130.31
2012	**144.67**

GS has increased BPS 16%/year since 1999, and importantly, BPS has increased every single year during the past decade and beyond despite the internet bubble and collapse, 9/11, Iraq/Afghanistan, financial crisis etc. Even since the peak of the bubble in 2007, BPS has increased at 10%/year.

Recent low ROE has been due to, according to management, conservatism on management's part because of the uncertainties with respect to the macro environment (Europe), regulatory/capital issues (which remain unclear) and lower client activity.

If they thought there was a permanent change in the environment, they would gladly buy back large amounts of stock and return capital to shareholders. They feel that this environment is temporary and want to hold capital so that they can deploy it when things normalize. Viniar has said that they would love to buy back more stock but don't want to be put in a position that when things start to move, they don't have enough capital to deploy.

It's no good to take management's comments at face value, of course. But on the other hand, if you don't trust the management, then you shouldn't be in the stock (unless there are other good reasons to own the stock; asset values or potential to replace the management etc...).

I do believe that GS is being conservative. This is very different from a company that can't earn high ROE even if it wants to and even in good environments. There is a difference.

GS is still an attractive stock to own, though it's not a no-brainer like it was when it was under $100.

Morgan Stanley (MS)

MS is an interesting situation. I was never really that interested in MS except for valuation reasons. It was just way too cheap, and it still may be.

I know that there are varying opinions on MS, but I am of the view that Purcell did destroy what MS was; when Mack came back, he rushed to get MS back into shape and got his traders to take huge risk to catch up to GS and others and he did it at precisely the wrong time and blew up spectacularly. What was left was not so inspiring. Even now, I don't see anything that exciting about MS.

But as I listened to the earnings call and flipped through some recent investor presentations (available at the MS website), one slide really stood out to me and I think was one of the factors that really made MS's stock price pop up a lot.

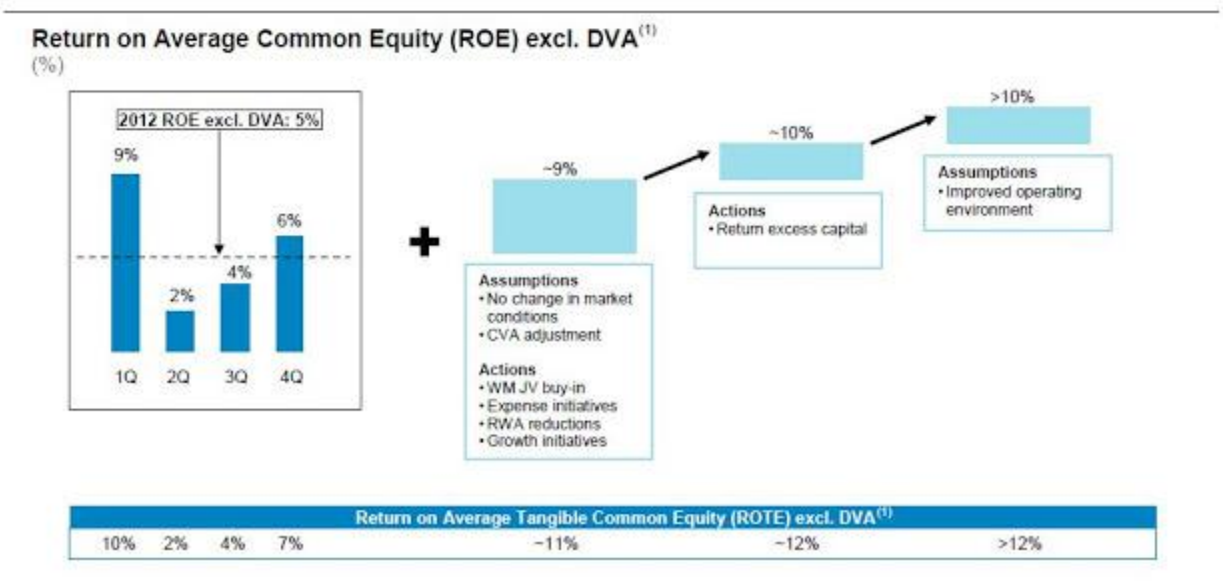
I was always wondering what was wrong with MS; why couldn't they earn better ROE? Merrill was doing fine. JPM was doing fine.

And then the below chart just hit me over the head. Maybe this was available before and I only noticed it recently. But this chart shows the roadmap for MS to get their ROE over 10%.

What struck me is that with the current plans in place, MS is on it's way to earn an ROE of 9-10%.

They can get to 9% with current plans and with no changes in the market environment. By returning excess capital, they can get it up to around 10%. If the operating environment improves, this can get ROE to over 10%.

It also helps that Dan Loeb is now long a bunch of MS. It's always nice when someone is there for the shareholder to make sure management follows through on plans and achieve their goals.



If the turnaround continues, MS can get back to at least BPS, which is up close to $30/share.

But...

So I do like the financials. I have liked them since late 2011 when I started posting about it on this blog. Financials have done well since then, but I do think most of them are still pretty cheap.

I think there is still a lot of fear. The press keeps talking about derivatives and leverage; people always worry about the last blowup and expect it to happen again really soon. But my bet is that that rarely happens; you don't get two similar blowups so close to each other. Yes, there is a financial crisis every few years. When the stock market crashed in 1987, people worried about another stock market crash for years thereafter (and it has yet to happen).

But I really doubt that there will be anything with the major banks in the next few years. Once people stop worrying about the last crash, money will start coming back to financials and valuations will normalize. And again, when I say 'normalize', I don't mean get back up to bubble levels.

On the other hand, I understand that financials are getting mighty popular these days. Someone who hated BAC at $5 is now saying it's a great buy at $12. I don't understand that, but that's how the street works.

Oh, and yes, there are a lot of other great banks and financial institutions. WFC, for example. It's a great bank. But I do think it's sort of fully valued, even though it's not at all a bad investment. It's not one that I would own now as I do like to buy things that are cheap that I think should be valued higher. WFC valuation looks OK now; not cheap. But the stock can do well when housing recovers more and they continue to increase earnings. But it's a different type of holding than I want in my portfolio at this point.

Financials Still Look Good: Part 1

JP Morgan Earnings

So JPM announced earnings and things look pretty good to me. Sure, there is still steady NIM pressure and this will be an issue this year too. I think they said it will be a $400 million or so headwind in 2013. But otherwise, things look pretty good.

I know people say that earnings actually aren't so great as they benefited from a refinancing boom and reserve releases, but I really don't find that a problem at this point. Reserve releases just means that they over-reserved in the past so to the extent that it benefits earnings now, it just means that earnings were less bad in the past. As for the refinancing boom, this is a function of lower interest rates so this offsets the NIM decline. There's nothing wrong with that.

Of course, at some point if conditions don't improve, reserve releases go away and mortgage refinancings peter out, it will put pressure on earnings for sure. This is definitely a concern.

But the way I see it, things are still in a pretty depressed state. Housing, for example, is recovering but is doing nothing compared to what it can do. I'm not talking about going back to the boom times of the mid-2000s, but a more solid, firmer recovery is very possible if not likely. In that case, all sorts of areas that are depressed now will start to come back slowly.

The investment bank too seems to be doing very well and it is hardly boom times in that area too.

I still think "normal" is much higher than here for the banks so any reduction in mortgage refinancings, reserve releases and stuff like that is something I fully expect will be offset by "normalization" in other areas.

Also, for many of the banks, legal and other costs are very elevated now and that will also start to come down over the next few years as these problems are settled.

In any case, I don't intend to get into the details, so I'll just look at one thing I do like to look at. First, let's remember what Dimon said in the 2011 annual report letter to shareholders:

Our tangible book value per share is a good, very conservative measure of shareholder value. If your assets and liabilities are properly valued, if your accounting is appropriately conservative, if you have real earnings without taking excessive risk and if you have strong franchises with defensible margins, tangible book value book value should be a very conservative measure of value.

So how did JPM do in 2012 based on tangible book value? Here's an update of the tangible book value per share from 2006 through 2012:

	Tangible BPS	Return on Tangible Equity
2006	$18.88	22%
2007	$21.96	21%
2008	$22.52	6%
2009	$27.09	11%
2010	$30.18	15%
2011	$33.69	15%
2012	**$38.75**	**15%**

So in a not so exciting year for the economy or the banking industry (remember the fiscal cliff?), JPM earned a return on tangible equity of 15%. And this is in the year of the whopping whale loss. Not bad at all, and we see how tangible book value can be a very conservative valuation for JPM.

Apple

OK, so let's take a detour for a second. The other day on CNBC, a prominent analyst explained his Apple stock price target of $750/share.

His rationale is that he sees AAPL earning EPS of $50 in 2013 and $60 next year. At the end of next year, he estimates they will have $200 billion in cash. Since a lot is overseas, take 75% of that cash and it comes to $150/share.

So 10x $60 estimate is $600/share plus $150/share in cash is $750.

Apple is stuck at around $500/share now so if Apple gets there in two years, that's a return of 22%/year. It should actually get there a little sooner than that as stock prices discount earnings before it is realized.

But let's just hold that thought for a moment. (I have more to say about Apple, but perhaps in a future post. I realize that Apple is now down 10%, but analyst price targets are apparently coming down now too, so I'll just leave the above alone).

Back to JPM
So tangible book value per share is a conservative estimate of the fair value of JPM. What is it worth? Given it's return on tangible equity record of the recent past and Dimon's statement that they should earn *at least* 15% ROTE over time, I think 1.5x tangible equity is not unreasonable at all.

Assuming JPM can grow tangible book value per share at 12%/year like it has in the recent past, that gets us to a tangible BPS of $48.61/share by the end of 2014. *Put a 1.5x multiple on it and yet get a stock price of $72.92/share.*

With the stock selling now at $46.50, that's *25%/year* return from here (before dividends), better than Apple!

OK, I am just comparing JPM to AAPL for fun so don't bother with the hate mail. I know the rest of the world far prefers Apple to an opaque, highly levered, scary bank. But I thought it was sort of interesting. This is not to suggest that JPM is a better investment than AAPL. JPM has a lot of risk and so does AAPL.

But What About NIM?!
NIM to me is still the primary risk in investing in banks. I don't worry about another whale loss at all. But we have to remember that banks are dynamic institutions, not static, unmanaged entities. If NIM continues to go down, then I am confident that unlike Japanese banks, it will be managed accordingly. If NIM becomes too thin, uneconomic loans won't be made. If certain business lines don't earn a hurdle return rate on capital, then the business won't be done. This is not how business is done in Japan (maybe more on that in a later post). If there is excess capital because of that, excess capital will be returned to shareholders.

As long as the bank(s) is well managed, I think things should be OK.

Whale Loss Report / Atlantic Magazine Article
I read the JP Morgan task force report on the CIO incident (see here) and it was a great read. Or, I should say, an unpleasant read for a shareholder. Does it scare me that this happened? Not really. It is actually quite shocking that they tried to manage such a large, complex position with billions in notional amount outstanding on a spreadsheet with a junior employee cutting and pasting data from one spreadsheet to another. There are other scary things in there.

But the reason why I am not so worried about this is that from the beginning I knew that this blowup occured because the CIO was treated differently than the rest of the company. It was sort of like a teacher's pet project; Dimon had such faith and confidence in Ina Drew that he gave her a lot of rope and didn't have the firm risk management on top of CIO like it had on other business lines. As far as Dimon was concerned, if Drew was OK, he didn't need to have anyone else check it out. I think that was the critical error on the part of Dimon and JPM.

So in that sense, it is highly unlikely that anyone else can be doing something similar elsewhere in the firm. Of course it's possible. Nobody can say it can't ever happen. But I feel like I understand the personal / political dynamic that was going on at JPM at the time.

I also quickly skimmed the recent *Atlantic Magazine* article on how a whale-like blow-up can happen again and I thought the article was ridiculous. This is not to say that it can't happen. But the article really doesn't raise anything new and uses large numbers that do tend to scare people, like the notional amount of derivatives sitting on bank balance sheets.

The article mentions that Bill Ackman thought "for once I thought you could trust the carrying values on bank books" after the crisis and bought $1 billion of Citigroup stock in 2010 and then sold out last year at a loss of $400 million. Ackman is quoted as saying, “For the first seven years of Pershing Square, I believed that an investor couldn’t invest in a giant bank. Then I felt I could invest in a bank, and I did—and I lost a lot of money doing it.”

But does this have anything to do with bank disclosure or bad trading on the part of Ackman? I don't think there was a disclosure/opacity issue responsible for his loss.

Notional Amount is Not Indicative of Risk
Also, as is usual in these articles, they raise the issue of the astoundingly large notional amounts of derivatives outstanding. Wells Fargo has $2.8 trillion on it's books, but that's nothing compared to $72 trillion on JPM's books. These are huge numbers. These figures are usually compared to GDPs.

This figure is really not all that relevant in measuring risk. I don't know if accounting and ISDA standards have changed since I've been in the business, but if it hasn't changed much, this notional amount is of very little value in measuring risk.

If I was a bank and you are a customer, you may want to fix your floating rate obligation. So we can do an interest rate swap where you pay me a fixed rate and I pay you a floating rate. Let's say we do this on a notional amount of $1 million. Then let's say short term interest rates go down and you think it will keep going down so you want to go back to paying a floating rate. We can do another swap on the $1 million. Then we have two swaps outstanding for a total notional amount of $2 million.

So the notional amount outstanding on my book went up from $1 million to $2 million, but my risk actually went down as my exposure to you has been eliminated by an offsetting swap. Under ISDA rules, whatever obligation we have to each other can be netted out. Go back and forth again two more times and my notional outstanding can go up to $4 million, but my risk including credit exposure to you, has not increased at all; in fact it can be absolutely zero. You would not know that from the $4 million outstanding notional amount figure.

People always talk about Buffett's costly unwinding of Gen Re's derivatives positions. The marks were good until they reached for it; once they started to trade out of it, the marks didn't reflect reality and it cost them a lot to get out of. And yet, Buffett personally owns a million shares of JPM stock with $72 trillion notional of weapons of mass destruction on the books.

How can this be? I think it's important to remember that the sort of derivatives on JPM's books and on someone like Gen Re's (or AIG's) can be very different in nature. Why? JPM's credit rating and role as lead bank for many large global blue chip corporations means that it is the primary counterparty for simple, plain vanilla derivatives used to hedge foreign currency and interest rate exposure. When Proctor and Gamble wants to hedge global FX risk, they do swaps with the likes of JPM or other major city bank. They typically will not go to AIG or Gen Re who are not their bankers.

A major corporation like IBM may sell bonds to the public; some institutions may have a need for floating rate instruments while IBM wants to offer fixed rate, straight debt. Someone like JPM can do the offering and do a swap with the investor (do a fix-float swap), or have IBM offer a floating rate bond and do a swap with IBM. This can happen across currencies (IBM may offer yen bonds, swap it into fixed dollar payments etc...).

This is why the major city banks have such large notional derivatives outstanding.

Why are other institutions' derivatives more toxic and tricky? It's because Gen Re, AIG and others can't compete and make money in plain vanilla derivatives. They can go to Johnson and Johnson and say, hey, we want to help you manage your interest rate risk. But they won't be able to compete with JNJ's bankers. It could be a credit rating issue or just a banking relationship issue (main banks may be willing to do hedging transactions for very low margin as part of maintaining a relationship. Pricing may also be more competitive as big money center banks have many similar counterparties to offset differing hedging needs etc... There is a network effect here too).

Most likely, it will be that JNJ will already have derivatives outstanding with a few of the large banks already and to do a deal with an existing counterparty is just more efficient from a documentation, collateral management, netting and other issues.

It's hard to break into that side of the business. This is why other institutions often have to compete in more exotic derivatives that are harder to price (and have wider spreads).

Also, most of the notional outstanding are FX or interest rate swaps. Very little of the notional outstanding is based on equities, commodities or other volatile instruments. Why is this important? Think about a fix-float swap. One counterparty agrees to pay fix and receive float from someone. If the counterparty goes under and if the swap is effectively terminated, future payments just stop. If the bust counterparty can't pay their fixed rate payment, then you don't pay your floating rate payment. There is no loss of principle or anything like that. What would usually happen is that there might be a hedging loss; whatever hedge you put on you will have to unwind and you may take a loss on it. Typically, such losses would be covered by collateral held so no loss would be incurred unless there was a large market move after the termination of the swap.

During the financial crisis, notional derivatives outstanding was not an indication of how much risk a bank had. In fact, people always thought that JPM would be the first domino to fall due to their derivatives book. (Critics will say if the financial system fell, JPM would have fallen too. Dimon denies that and I side with Dimon on that one (or at least he said they would have been fine even if things got far worse; I don't know about a total collapse). But either way, if the financial system failed and everyone went under, then it would be moot anyway; banks with less derivatives outstanding would have failed too).

The first banks to fall were the subprime lenders, then some of the regional banks like IndyMac and Wamu (not known for large derivatives outstanding). Bear Stearns and Lehman both failed due to pretty plain vanilla positions (mortgages in the case of BSC and commercial real estate loans in the case of Lehman (the then CFO did say that commercial real estate loans was what killed Lehman; they were plain vanilla, straight loans). AIG failed due to derivatives, yes. But it wasn't the size that did them in but the one-sided, unhedged bets that killed them (and they were neither a bank nor an investment bank). Citigroup's large losses occured in SIVs, a security that didn't even appear on the balance sheet; it had nothing to do with the notional derivatives outstanding.

This is not to say that there isn't some funky stuff in JPM or WFC's derivatives books. There usually are some funky/exotic things in any book. But they tend to be a very small part of the trillions in notional outstanding.

Other Losses

The article also mentioned a proprietary trading loss of $14 million and an economic hedging loss of $1 million (at Wells Fargo) and noted that these figures are small, but how do we know how big it could have gotten? They talk about these small losses and tell us that it could have been far, far worse, but we wouldn't know because Wells Fargo doesn't tell us how much risk they are taking. I found this to be reaching a bit too much. This seems a bit silly to me.

This is not to say that there aren't any risks. Banks / investment banks are risky businesses.

OK, I was going to talk about Bank of America, Goldman Sachs and Morgan Stanley (just brief comments, nothing deep) but this post is already really long so I'll send this out first and finish my thought in the next post. Plus I haven't posted in a while so it'd be nice to get something out there now.

Posted by kk at 12:31 PM 6 comments:
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Links to this post
Labels: BAC, GS, JPM, MS, WFC

Thursday, July 19, 2012

Wells Fargo-Goldman Sachs Merger

(Warning: The above title is a title of a blog post, not a news headline!)

OK, so I asked in my last post if GS would be better off as part of a bigger bank and I couldn't put that thought away. In the past there were rumored merger partners like Wachovia (that was just during the crisis, though), AIG and HSBC (and some others; WFC might have been mentioned during the crisis).

But WFC kept coming to mind. Both WFC and GS are owned by Buffett and he loves both of them.

First of all, this is just for fun. I know this is a long shot and in this political/regulatory/public sentiment environment, this is probably not going to happen (if GS is an octopus, what would you call WFC-GS?!). But this is a blog so I can write whatever I want, so that's what I'm going to do.

Also, it's a little silly to react too much to short term trends. I did say the independent investment banks are doing horribly compared to ones that are part of bigger banks. Morgan Stanley just announced their 2Q and it just confirms this.

So let's add MS to the table from my other post about Merrill:

Independent investment banks

	2Q ROE	6 month ROE
GS:	5.4%	8.8%
MS:	3.5%	1.4%

IB's as part of bigger banks:

	2Q ROE	6 month ROE
JPM (IB):	19%	18%
JPM (AM):	22%	22%
BAC/MER:	12%	13%

The difference is quite clear. MS's result is horrible. The market environment is bad, but is it really *that* bad? I don't know. The results are horrible, though.

What's stunning about MS is that it's horrible across the board.

From their earnings supplement, here are the returns on average equity for the the various MS segments:

	6 months periods 2012	2011
Institutional securities	0%	0%
Global wealth management	5%	2%
Asset management	3%	*
Total	1%	1%

I haven't been following MS too closely but I am a bit surprised that shareholders have been so patient there. Again, look at JPM's returns and that includes the big whale loss! How can MS not make money?

Investment Banks Better off Inside of Other Banks

OK, so MS may be horribly mismanaged but the fact that the usually very well-managed GS is not doing too well either may imply that investment banks may actually be better off inside other banks. This is just something that comes to mind just by looking at the facts (even though admittedly, the facts are very short term and may not be indicative of long term 'facts').

Wells Fargo-Goldman Sachs?

So this idea leads me to the Wells Fargo-Goldman Sachs merger idea. First thing that you are going to think of is what it's going to be called (OK, maybe not the first thing or second thing...).

Wells Goldman
Wells Sachs
Fargo Goldman
Fargo Sachs
Goldman Wells
Goldman Fargo

OK, so none of these really click so let's move on.

As JPM, BAC and WFC grow domestically as the largest banks, increasingly competing in major metropolitan centers like NYC, it's interesting to note that both JPM and BAC have large investment banks. C, which I haven't included here also has a large investment bank.

WFC stands out as not having a large investment bank even though they do have a wealth management/brokerage segment.

So in that sense, WFC-GS might make sense. Of course, just because everyone else has something is no reason to get one for yourself. But still, let's keep looking at this.

First let's take a look at the other large integrated banks:

	($bn) Total assets	Equity	Equity of IB
JPM	$2,266	$176	$47
BAC	$2,296	$212	$66
WFC	$1,314	$140	(n.a.?)
GS	$923	$69	$69
WFC-GS	**$2,237**	**$209**	**$69**

So look at that! GS fits like a glove into WFC and puts it into the ballpark of JPM and BAC in terms of asset size, equity and equity invested in the investment banking business (The JPM IB equity includes $40 billion for the IB and $7 billion in their asset management business).

It fits so well it seems almost inevitable!

(WFC does have wealth management and brokerage, so the equity in that business is not zero but it's not disclosed separately (I don't think), and it's not that big)

From this point of view, it looks completely normal and reasonable.

The Merger

OK, so this is a big deal. I briefly thought about BRK just buying GS outright, but realized that there would be some regulatory issues (don't ask me what; I don't know exactly, but it would probably be complicated). Plus, a market cap of $47.6 billion of GS is a bit much for even Buffett to swallow now (but you never know!). He is looking for a $20 billion whale, and maybe even a $30 billion one if cash keeps accumulating.

Buffett has said that every bone in his body tells him to hold on to his GS warrants, so we know he really likes the business and the management.

Anyway, back to the WFC-GS merger. Since this is a whopper of a deal, the best way this can be done now would be a stock-for-stock merger. Why?

Because WFC is trading at 1.3x book and GS is trading under book, it would be deliciously accretive to WFC! Why not?

Of course, I doubt GS would sell itself at under book value, and certainly not 30% below book value.

But let's take a look at this anyway. This is a blog, not a deal book (so I can do what I want!).

As of the end of 2Q2012, here are the relevant figures:

	WFC	**GS**
BPS:	$26.06	$137.00
SOS:	5.3 billion	500 million
Common equity:	$138 billion	$68 billion
Stock Price:	$34.00	$96.00
Market Cap:	$180 billion	$48 billion
P/B ratio:	1.3x	0.7x

So at current prices, WFC would need to issue 1.4 billion shares to take out GS. What would happen if the deal gets done right now at these levels?

After the deal, WFC would look like this:

Common equity:	$206 billion
Shares outstanding:	6.7 billion
BPS:	$30.74/share

So this deal would be accretive by $4.70/share, or 18%. That's a nice bump in BPS. How many years would it take for MS to do that on it's own? Or even GS?

Of course, with market sentiment the way it is, the market may not increase the valuation of WFC on this merger and in fact may reduce it (the market is already telling us that it doesn't like the investment banking business, as the one bank that doesn't have a major IB attached to it is trading at a higher P/B than the other two (JPM and BAC) and independent investment banks are trading below book).

But a lot of that might be offset if GS can generate higher ROE within WFC than on it's own. The most important reason why investment banks are trading below book is their single digit ROE.

Benefits of a Merger

There are a bunch of reasons why this merger would be good and of course many that would be bad. First of all, I would think that the regulatory and political environment would be very bad for this deal. I'm not sure WFC wants the headache of having to worry about the Volcker rule and other regulatory issues.

On the other hand, the benefits that immediately come to mind are:

- Cross selling of products throughout merged bank
- Capital efficiency of having a more diversified business model

I'm sure there are plenty of other pros and cons, but I am just jotting down things that come to mind off the top of my head.

I think both MER and JPM are doing better than GS and MS partly because of the cross-selling advantage. Dimon has mentioned that in the past.

Also, capital efficiency is another big plus, even though I understand most people would disagree with me and say that hiding a risky investment bank behind an FDIC/taxpayer supported bank is a horrible idea. I've never subscribed to that view, but of course I understand this deal would be a nightmare for folks who do take that view.

Conclusion

I don't necessarily advocate this merger even though the more I think about it the better it sounds. As an investor, we can't just react to short term results and events and seek instant gratification.

I still think it's a good idea to look at investments and evaluate them on what you think they can earn in a more normalized environment five years out or so. So this above analysis clearly is short-term oriented; I am reacting to the poor results at independent investment banks over the past 12-18 months.

I don't know about MS, but I still like GS and think they will do very well over time. I do believe that this conservatism is short-term based on the uncertainties and heightened risk of a total financial blowup in Europe (and GS doesn't want to get caught with it's pants down; there would be no political will for any sort of rescue next time around).

But it is something that came to mind as I go over these results, so I just jotted it down (for fun!).

And I know, this post goes against everything everybody seems to be saying.

1:08 PM 6 comments:

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Links to this post
Labels: GS, WFC

Tuesday, July 17, 2012

Wall Street Firms Only for Employees?

So I keep hearing people say that Wall Street firms exist only for their employees. One guy on Bloomberg TV said that GS only exists for it's employees; why not get that compensation down and return some of it to shareholders?

As proof that GS exists only for the employees, he states that compensation is 40-50% of net revenues.

OK, so let's think about this for a second. Is it really true that GS only exists for employees? If someone started a business only for the benefit of the employees, can it really exist for a long time? I tend to doubt that. We have heard so much how awful GS is despite the "muppet" story and Fabulous Fab etc. Are people really that stupid and irrational to keep doing business with these awful people? Or does GS actually provide a service that people want to pay for?

Compensation Ratio
Anyway, first of all let's think about this 40-50% compensation expense ratio. Banking is a service business and it makes sense that much of the expense in a service business is labor cost. Unfortunately, there isn't much detail in financial disclosures to calculate labor costs in various industries.

One industry where labor cost is disclosed is the restaurant business, which is a service business. McDonald's has a breakdown of costs for their owned restaurants. From that we see that owned restaurant labor costs as a percentage of restaurant sales is 25%. But wait a minute; banks and investment banks report revenues as "net" revenues, net of interest expense which is basically their cost of goods sold.

So let's look at labor costs at McDonalds as a percentage of "net" revenues (revenues less cost of food and paper). That comes to 38%.

So 38% of McDonalds restaurant sales (net of cost of goods sold) go to payroll and benefits. McDonalds, too, then exist only for their employees? By this definition, yes. McDonalds restaurants only exist for the employees.

How about another restaurant? Darden Restaurants is a large chain restaurant. I am not cherry-picking any names here; that's the first one that came to mind that seems like a 'typical' chain restaurant (that runs "owned" restaurants versus franchises them which have different economics).

Labor costs at Darden is 32% of sales. If you exclude cost of goods sold, then labor costs is 45% of "net" sales. So I suppose Darden restaurants too only exist for their employees according to this person that is complaining that GS only exists for their employees.

How about another one? I remember Dimon mentioning newspapers when he commented on this issue.

Again, I am not picking names that make my point. The first pure play newspaper that comes to mind is the New York Times. Wages and benefits at NYT in 2011 were 37% of total revenues. That's 37%. Yup. New York Times too exist only for their employees.

How does this 37% compare to the evil banks?

Compensation and benefits expense as a percentage of net revenues for the three financial firms I mention often here are:

GS: 42%
JPM: 30%
WFC: 34%

These are all figures for the full year 2011.

OK, so maybe I am reaching here a little bit. Fine.

Let's look at this another way then.

People keep saying that GS (and other investment banks and banks) exist only for their employees but let's look at shareholders.

I already mentioned how great JPM has done for shareholders throughout the crisis. You can see growth in tangible book and book value per share over time, plus JPM pays a nice dividend even now.

Here's the post on the JPM 2Q.

It looks to me like JPM is doing fine for shareholders.

GS No Good For Shareholders?
OK, fine you say. JPM has a lower compensation ratio than even the New York Times. And they have done well for shareholders over time (management can't control stock price so you have to look at ROE, growth in BPS etc...).

Let's see how the poor GS shareholder has done (I'm just cutting and pasting here from an old post):

- The average ROE from 2001-2011 is 17.2%, and for the last five years it's been 15.1%.

That looks good to me. How many companies have achieved that? I'm sure New York Times shareholders would love performance like that!

BPS for some key years were:

	2006	2007	2011
BPS	$72.62	$90.43	$130.31
TBPS	$61.47	$78.88	$119.72

- Since the peak in 2007, GS grew BPS by +9.6%/year and tangible BPS by +11%/year.
- For five years, the respective growth rates were +12.4%/year and +14.3%/year.
- For the past decade, 2001-2011, BPS grew +13.6%/year.

That looks pretty impressive to me. How many companies have achieved something like this, especially after all that has happened in the past decade?

Anyway, it doesn't really matter what people say but when people keep saying something over and over without looking at the facts, it gets a little annoying and I can't NOT point it out. It's a little disappointing that so many reporters and commentators have been in the business for many, many years and still don't seem to check the simple facts before commenting. There are a lot of people saying a lot of things all the time and a lot of it has no basis in fact! Beware of these people.

Monday, June 18, 2012

Net Interest Margins etc.

I mentioned recently that what I fear most for U.S. banks is what happened in Japan; low interest rates for a long time. If long term interest rates keep going lower, this will put pressure on bank net interest margins and therefore profits.

So I decided to take a quick look at this and found something interesting. People used to use yield spreads as a proxy for bank profit margins. The ones that you would hear about were the 10 year treasury rates versus 2 year rates or Fed Funds rate or some such thing. When that was wide, bank margins were wide and vice versa.

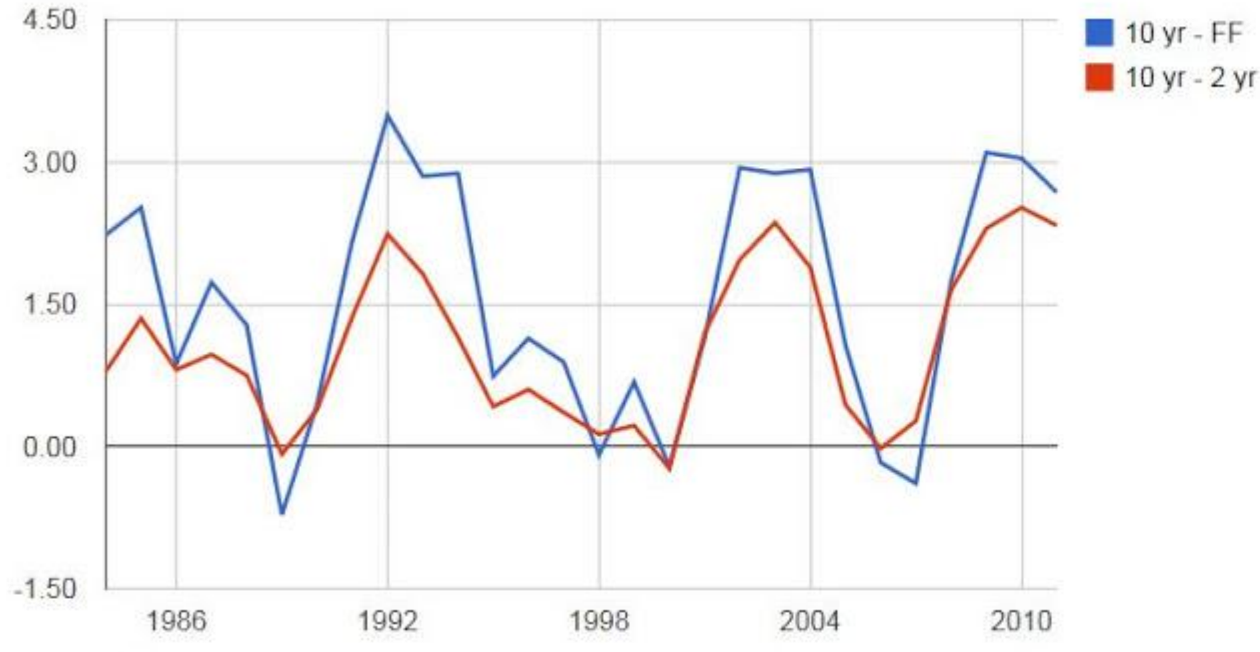
Anyway, the following are just some thoughts. Don't read this if you want answers. I have no idea, frankly, if the U.S. will follow Japan; I have no idea how long interest rates will stay low. I do actually have a hunch that it will stay low for a lot longer than most people think, though, but that doesn't mean I think we are in for a Japan scenario.

And keep in mind, I am not predicting a Japan scenario here. It is my personal, primary risk scenario, not the base-case scenario. My base-case scenario, perhaps naively, is that we just muddle along and do OK. Other risk scenarios are of spiking interest rates and hyper-inflation. I tend to lean more towards the deflationary collapse risk side than the hyper-inflation side.

In any case, I don't know which we will see if any. This post will not try to answer that question, nor will this try to figure out if WFC and other banks are good buys here or not. I just wanted to take a closer look at the moving parts, that's all. Think of it as a meditation on NIM, or whatever...

Yield Curve Spread
Anyway, since NIM is my primary concern, naturally, the first thing I should look at is the yield curve spread. Here's a long term and shorter term chart of both yield spreads:

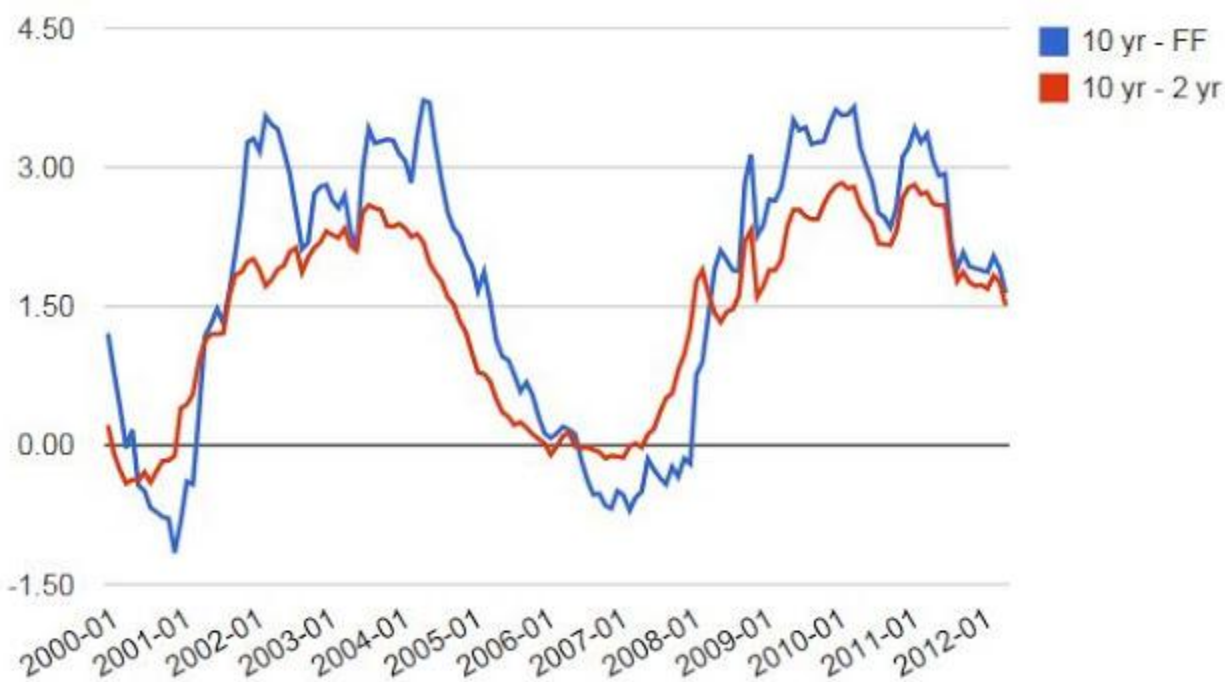
Yield Curve Spread
(10 yr versus FF rate and 10 yr versus 2 yr, annual data)



This is the two spreads going back to 1985. Any further back may not be as important due to Reg Q (regulated interest rates) etc. This chart goes to the end of 2011. So despite very low long term rates, as of the end of 2011, spreads were still at the *upper* end of the range since the 1980s. Of course, that's due to the very low short term interest rates. As of the end of 2011, you can safely say that the low interest rates on the short end of the curve has been very beneficial to banks.

Here's the same data on a monthly basis since 2000 and through the end of May:

Yield Curve Spread
(10 yr versus FF rate and 10 yr versus 2 yr, monthly data)



So even including the recent plunge in long term rates, the spread is still just about in the middle of the range; the spread is not abnormally low at all. 1.8% is the end of May figure (actually, average for the month of May) for the 10 year treasury rate, and as of now that's 1.62%.

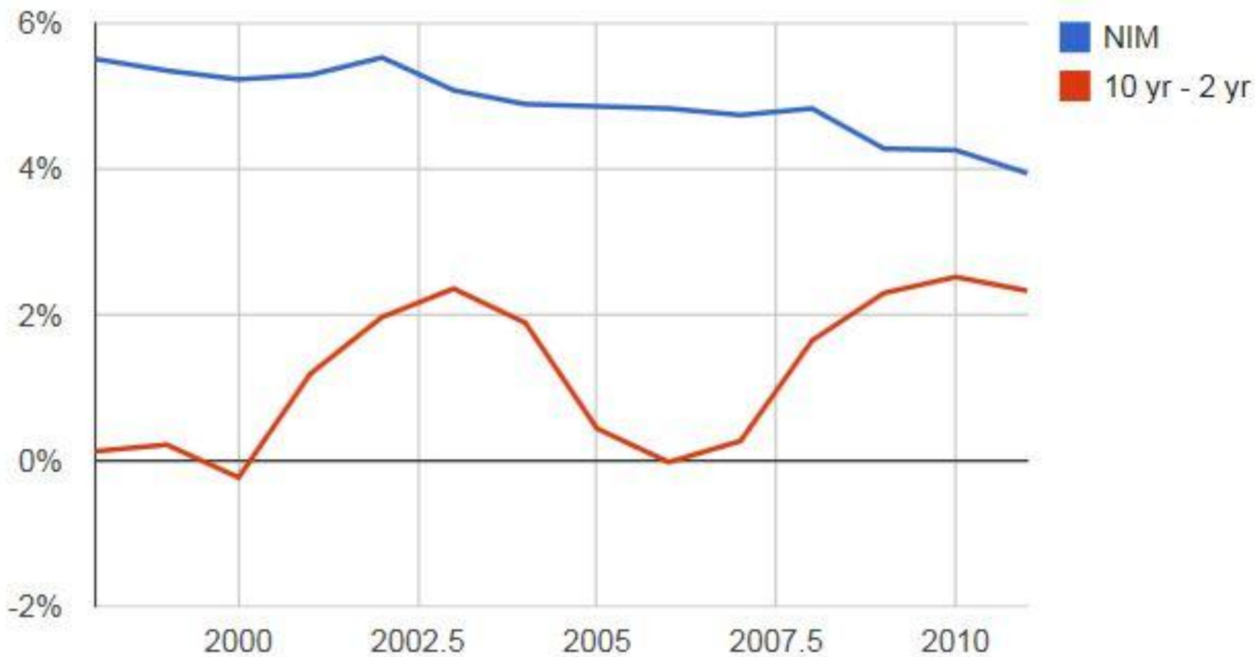
So far, even though long term interest rates have come down to abnormally low levels, thanks to the super-low short end, spreads are still within 'normal' range.

That's good news; despite declining long term rates, the yield curve is still positively sloping enough to be 'normal'.

Yield Curve Spread and NIM

So how does the above compare to bank NIMs? Here is some annual data for Wells Fargo (WFC) going back to 1998 or so. I plotted the NIM against the 10-2 Treasury yield spread.

Wells Fargo NIM vs. 10-2 spread



So here again is good news and then bad news. The good news is that WFC's NIM doesn't seem too correlated to the spread. That is due to various factors; asset-liability management, the maturity of loans (so don't reprice immediately etc). The yield curve flattened in 2000 and 2005-2007, but WFC seemed to maintain their NIM. That's the good news.

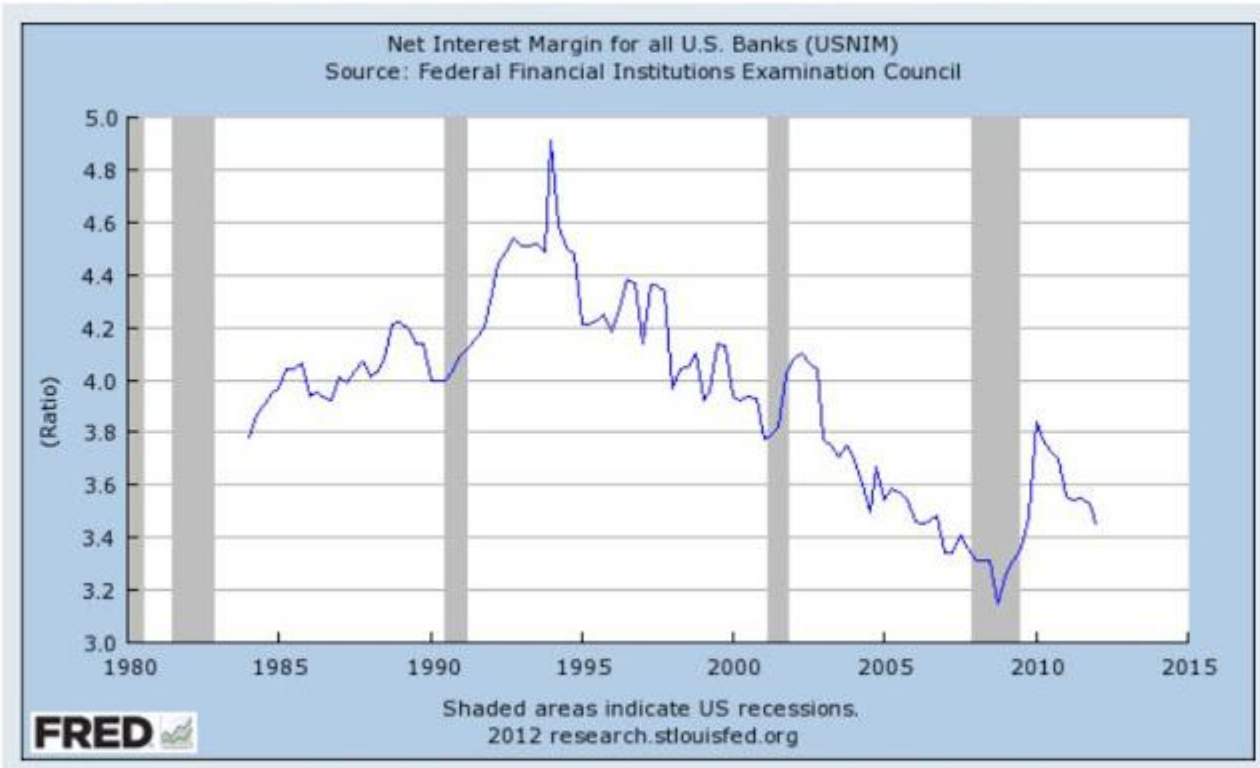
The bad news is that NIM has been trending down over time regardless of the spread.

Here is the NIM for all banks from a FED website. It's the quarterly NIM for all banks. This too, shows a steadily declining trend in NIM regardless of the yield curve.

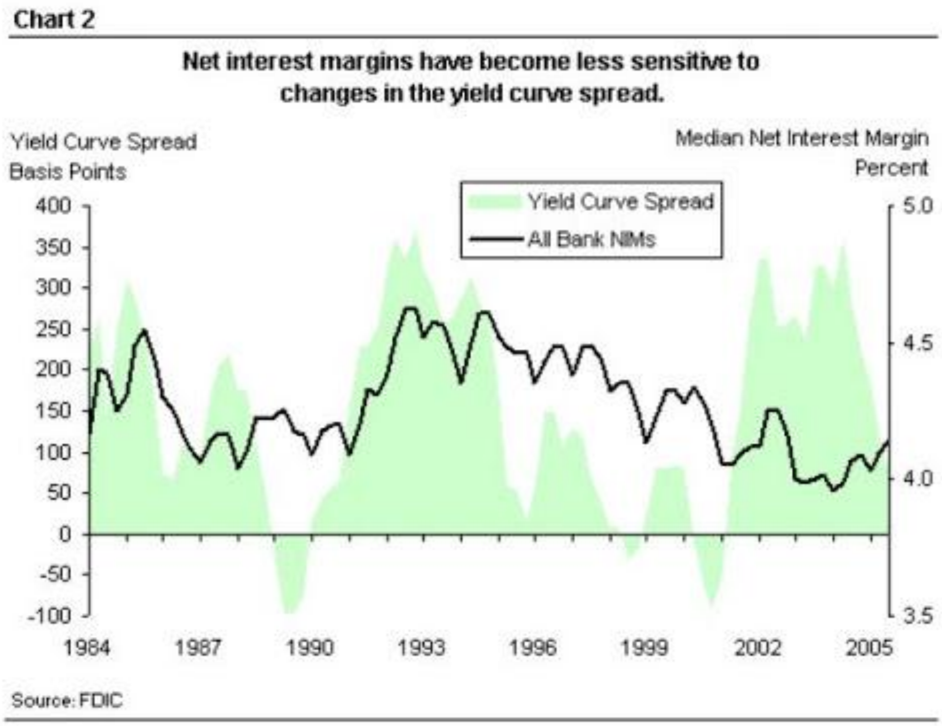
Net Interest Margin for all U.S. Banks (USNIM)

2012:Q1: **3.45** Ratio Last 5 Observations

Quarterly, End of Period, Not Seasonally Adjusted, Updated: 2012-06-04 3:16 PM CDT



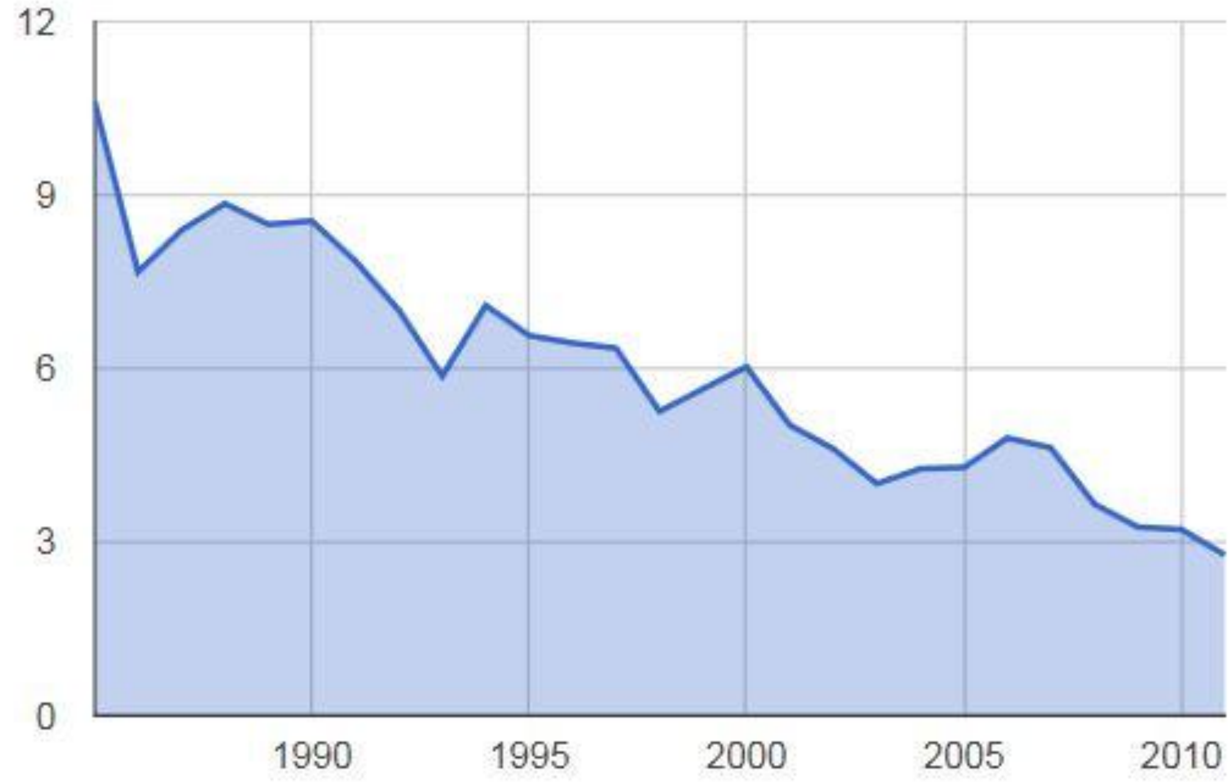
This is from an FDIC study on net interest margins and yield curve spread back in 2006. They do note the decline in correlation between bank NIMs and the yield curve:



The fairly tight correlation between changes in the yield curve and NIMs, however, generally held true only through the mid-1990s. It has weakened since then. The correlation between changes in the yield curve spread and bank NIMs with a two-quarter lag was 70 percent between 1984 and 1994. Since 1994, the correlation has fallen to negative 17 percent, suggesting that there has been very little systematic relationship between NIMs and changes in the yield curve spread over the past decade. For example, since the yield curve began to flatten during mid-2004, NIMs at FDIC-insured institutions have risen from just under 4.00 percent to 4.14 percent in third quarter 2005.

Just for reference, here's the 10-year yield:

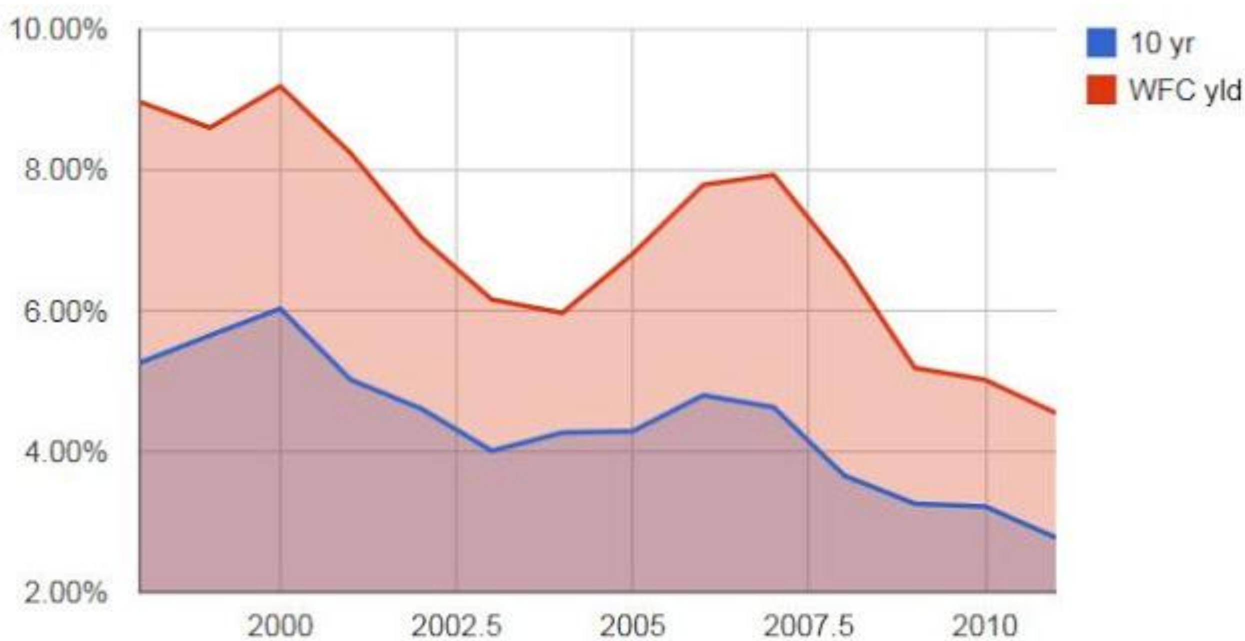
10-Year Treasury Yield (annual averages)



So What Does That Mean?
Since the yield curve spread isn't helping us see what's going on with NIM, let's take a look at the actual components.

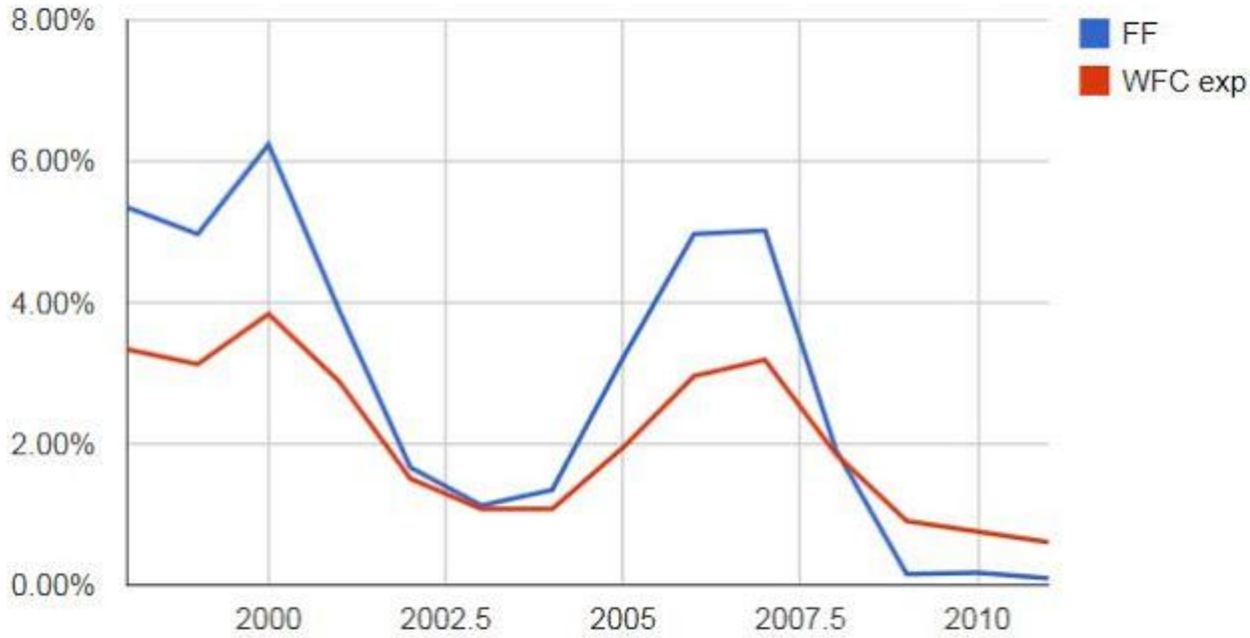
First, we'll look at the asset side of the balance sheet.

Yield on Interest Earning Assets at WFC versus 10-year Treasury Yield



Since 1998, the 10 year Treasury yield has declined from 5.26% to 2.78% and the yield on earning assets at WFC declined from 8.97% to 4.55%.

WFC Funding Cost versus FF Rate



On the liability side, WFC's funding cost has fluctuated above and below the FF rate. Overall, during this period, funding cost has declined from 3.34% to 0.61%.

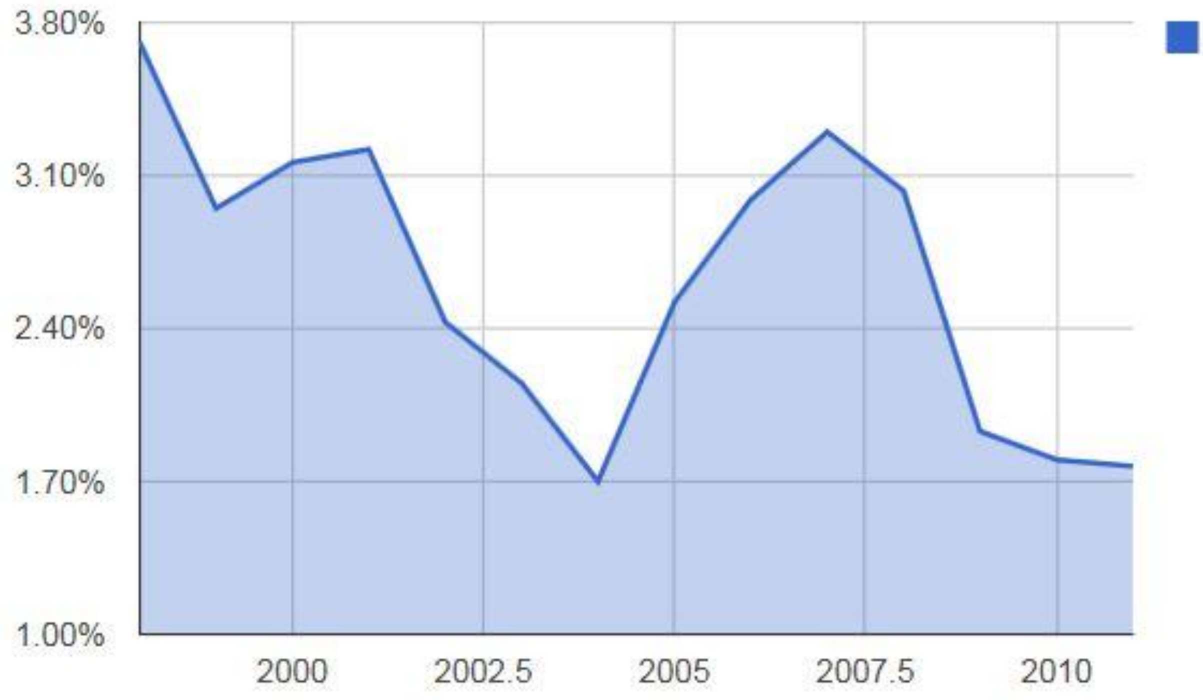
So the yield on earning assets declined 4.4% while funding cost only declined 2.73% for a spread compression of 1.67%. There is our 1.6% NIM compression from 5.5% to 4% or so (well, that's kind of obvious in a declining interest rate environment; no charts needed to tell us that!).

It seems like banks are not correlated at all to the yield curve spread, but are now just correlated to long term interest rates. That can't be good news in this environment.

But let's take a close look at the asset side to see how much of the NIM compression or decline in yield is due to a lower treasury rate and how much due to tighter loan spreads.

Below is the chart that shows the difference between the yield on earning assets spread versus the 10-year treasury rate:

WFC Yield on Earning Assets minus 10-year Treasury Rate

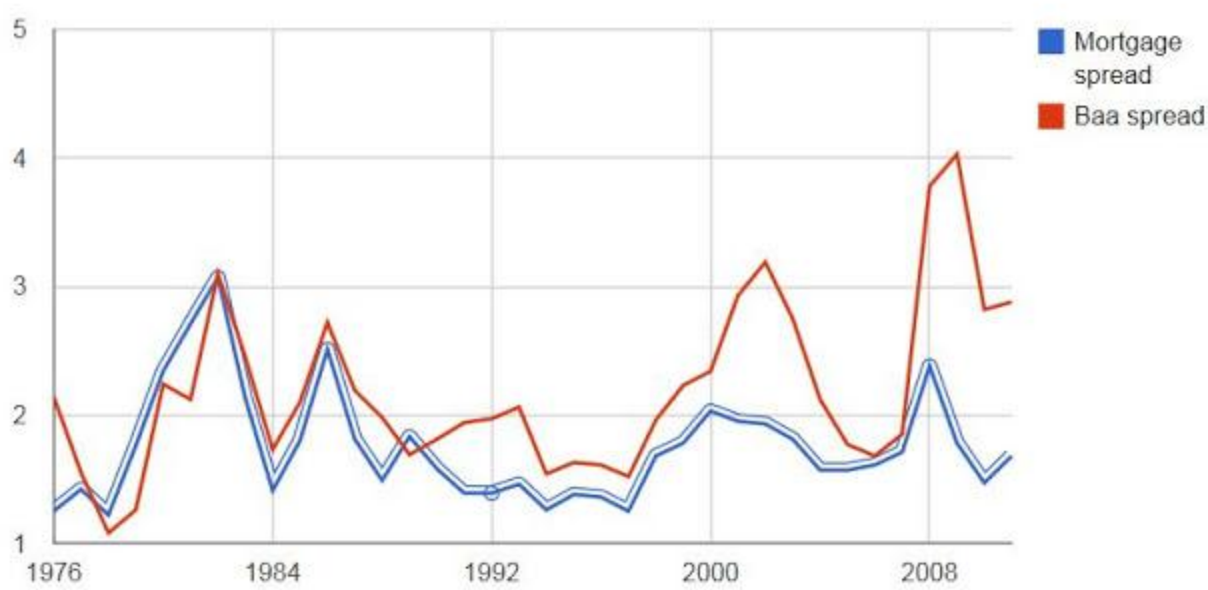


From here, we can see that a lot of the decline is due to a decline in the spread.

WFC yield on earning assets went from 8.97% in 1998 to 4.55% in 2011, a decline of 4.42%. The ten year treasury rate went from 5.25% to 2.78% during that time (annual averages) for a decline of 2.48%, so 56% of the decline in yield is due to lower interest rates in general. The rest comes from a decline in the above spread.

Is this due to change in mix or declining loan spreads? As a quick proxy I just grabbed some data on rates for conventional mortgages and Moody's Baa industrial bond spreads.

Spread Versus 10-year Treasuries: Conventional Mortgages and Baa Industrial



The above chart doesn't show the whole picture, of course, but it doesn't look like spreads are at particularly low levels today than in the past (going back to 1976).

The other explanation obviously has to be asset mix. In the above chart showing the difference between yield on earning assets and treasuries, it's interesting that the last dip occured in 2002-2003, which were weak years in the economy. Banks tend to invest in treasuries and other securities and make less loans in a weak economic environments which may be the case now.

Asset Mix
So if the decline in yield on earning assets spread (versus 10-year treasuries) is not due to declining loan spreads, it can only be asset mix.

Here's the asset mix for WFC since 2004:

Well's Fargo's Interest Earning Assets

($bn)	Total debt securities AFS	Commercial Loans (incl RE)	%	Consumer loans	%	Total earning assets	Total assets
2004	33	92	25.99%	175	49.44%	354	411
2005	33	104	27.08%	188	48.96%	384	446
2006	54	115	27.64%	185	44.47%	416	486
2007	57	134	30.04%	204	45.74%	446	521
2008	86	167	31.93%	224	42.83%	523	604
2009	176	333	30.36%	459	41.84%	1,097	1,262
2010	154	323	30.36%	448	42.11%	1,064	1,227
2011	175	331	30.04%	426	38.66%	1,102	1,270

What I suspected was that during bad economic times, banks would make less loans and invest more in low yielding fixed income securities (like JPM's controversial $370 billion bond portfolio). WFC management has also said during conference calls that some of the recent NIM declines were due to deposit growth outpacing their ability to make good loans; cash piles up in treasuries and other low-yielding securities decreasing yields on earning assets.

The above table does indeed show an increase in total debt securities available for sale over the past few years. The only problem with that is that it looks like the yield on available for sale debt securities is actually higher than the total yield on all earning assets (5.21% versus 4.55% in 2011 and 6.63% versus 5.02% in 2010). This may have something to do with a legacy portfolio from the Wachovia acquisition.

However, it is notable that consumer loans have declined from 49.44% to 38.66% from 2004 to 2011. That's a pretty large drop, and commercial loans went up from 26% to 30%. It looks like commercial loan yields are much lower than consumer loan yields so that would certainly be a factor in declining NIM.

I think typically the earnings asset yield is linked to the percentage of total loans to total earning assets (or total assets) as loans tend to have higher yields than securities (that banks typically buy with deposits not lent out).

Below are the figures for WFC:

Breakdown of Total Loans and AFS Debv to Total Assets

	Total loans/ total earning assets	Total loans/ total assets	AFS debt/ total assets
2004	75.42%	64.96%	8.03%
2005	76.04%	65.47%	7.40%
2006	72.12%	61.73%	11.11%
2007	75.78%	64.88%	10.94%
2008	74.76%	64.74%	14.24%
2009	72.20%	62.76%	13.95%
2010	72.46%	62.84%	12.55%
2011	68.69%	59.61%	13.78%

So even though yields on AFS debt has been higher than the overall yield, that hasn't always been the case; for a while, consumer loans had much higher yields than AFS debt so over time this may certainly be a factor in declining yields.

To get more color on how all of this impacts yield and NIM, I just jotted down yields on the major earning asset categories at WFC, and here it is:

Yield on Earning Assets by Major Categories (WFC)

	10 yr rate	Consumer loans	spd vs 10yr	Commercial loans	spd vs 10yr	AFS debt sec	spd vs 10yr	Earning assets	spd vs 10 yr
2001	**5.02%**	9.75%	4.73%	7.96%	2.94%	7.32%	2.30%	8.24%	3.22%
2002	**4.61%**	8.20%	3.59%	6.48%	1.87%	7.25%	2.64%	7.04%	2.43%
2003	**4.01%**	6.85%	2.84%	5.80%	1.79%	7.32%	3.31%	6.16%	2.15%
2004	**4.27%**	6.38%	2.11%	5.62%	1.35%	6.24%	1.97%	5.97%	1.70%
2005	**4.29%**	7.36%	3.07%	6.58%	2.29%	6.24%	1.95%	6.81%	2.52%
2006	**4.80%**	8.57%	3.77%	7.78%	2.98%	6.31%	1.51%	7.79%	2.99%
2007	**4.63%**	8.71%	4.08%	7.82%	3.19%	6.34%	1.71%	7.93%	3.30%
2008	**3.66%**	7.60%	3.94%	5.90%	2.24%	6.22%	2.56%	6.69%	3.03%
2009	**3.26%**	5.85%	2.59%	4.08%	0.82%	6.73%	3.47%	5.19%	1.93%
2010	**3.22%**	5.68%	2.46%	4.45%	1.23%	6.63%	3.41%	5.02%	1.80%
2011	**2.78%**	5.46%	2.68%	4.24%	1.46%	5.21%	2.43%	4.55%	1.77%

I just put the 10-year treasury rate and spread in there for reference; of course we don't know the terms of the loans and they are most likely not 10 years, so this isn't apples to apples.

You will see that consumer loans usually have much higher spreads than the other categories. So the declining percentage of assets going to consumer loans is a big factor (other than declining overall interest rates, which accounted for about half of the decline in yields since 1998), which makes intuitive sense.

And contrary to the spread chart above where I compared 10-year treasuries to rates on conventional mortgages and Moody's Baa Industrial bond yields, there does appear to be spread compression in WFC's book. But this, of course, may be due to mix; they may be more selective in making loans and making only high quality loans (and therefore earning less yield). This is consistent with what is understood to be going on in the industry. WFC has said in conference calls that they are not seeing spread compression due to competition between lenders.

ROAA and ROAE

So how does all of this affect return on assets and return on equity? Just out of curiosity I just jotted down the return on average assets (ROAA) and return on average equity (ROAE) of WFC since 1997.

Return on Average Assets and Equity of Wells Fargo

($billions except % and leverage (x))

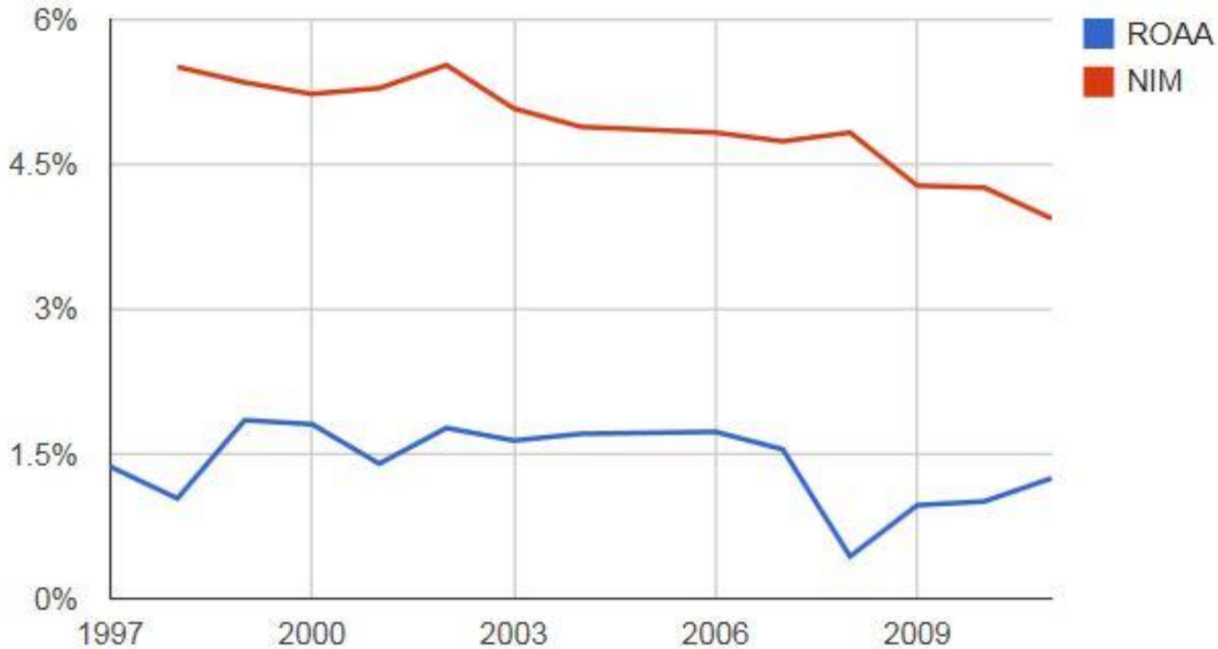
	Total assets	Common shareholders equity	ROAA	ROAE	Total assets / equity
1997	186	19.3	1.37%	12.81%	9.64
1998	202	20.3	1.04%	9.86%	9.95
1999	218	21.9	1.85%	17.66%	9.95
2000	272	26.5	1.81%	18.53%	10.26
2001	308	27.2	1.40%	14.94%	11.32
2002	349	30.3	1.77%	19.60%	11.52
2003	388	34.5	1.64%	19.36%	11.25
2004	428	37.9	1.71%	19.56%	11.29
2005	482	40.7	1.72%	19.57%	11.84
2006	482	45.8	1.73%	19.52%	10.52
2007	575	47.6	1.55%	17.12%	12.08
2008	1,310	99.1	0.44%	4.79%	13.22
2009	1,244	111.8	0.97%	9.88%	11.13
2010	1,258	126.4	1.01%	10.33%	9.95
2011	1,314	140.2	1.25%	11.93%	9.37
			1.42%	**15.03%**	

I also added the ratio of total assets to shareholders equity so we can see how 'leverage' impacts ROE over time. The argument is that banks can't be as levered as they used to be so looking at this would give us an idea on the impact of such changes in leverage going forward.

Anyway, it looks like despite low interest rates, WFC was able to earn an ROA of 1.25% versus an average since 1997 of 1.42%. In good times WFC seems to earn ROA of 1.7-1.8% area, and this may be possible again in a stronger economy. They are earning over 1.0% in this horrible environment so that's encouraging.

ROE at around 12% is slightly below the 15% average since 1997 and that is due to both a slight decrease in leverage and lower ROA. But again, this is in a very weak environment with housing still flat on it's back.

ROAA versus NIM



So naturally, we would want to see ROAA versus NIM to see what declining NIMs has done to it over time. It looks like WFC was able to maintain decent ROAA despite decreasing interest rates and NIM.

NIM is not a risk-adjusted figure, so that sort of makes sense. When you make risky loans, NIM goes up, but so does loan losses. If you manage the portfolio well, NIM can go down but profits can stay stable if you make better loans and write off less. This is what I guess is happening at WFC (and other banks). Non-interest income from fees also helps mitigate the decline in NIMs.

If the economy starts to pick up and housing starts to move (as many people are starting to expect), then I wouldn't be surprised if WFC starts to earn over 1.5% on assets despite the interest rate environment (and interest rates may go up if housing recovers too, but it may not since global interest rates may be under pressure due to the deleveraging that still needs to take place around the world).

Conclusion

It's interesting to see that despite dramatically lower long term interest rates, the yield curve is still well within the historical range. If rates stay down here, banks can still do OK as long as they can make decent loans. There is nothing in the term structure of interest rates now that says banks can't do well.

However, if interest rates keep going down, then this will obviously be a problem. This would indicate a weak economy for a longer time so loans probably won't increase too much and there may not be much opportunity to make higher yielding loans; increasing credit quality of portfolio may lead to lower and lower yields as has been the case in the past few years.

Obviously the economy would need to pick up for WFC to see loan growth and expanding interest rate margins.

It is interesting to see that NIM continued to decline even in the very strong economy of 2005-2007. At the time, I think the argument was that irrational, non-banks and securitization markets caused loan rates to go down to unreasonable levels, but that's not really proven in the chart comparing earning asset yields to Treasuries; the spread was fat in the good years.

In any case, WFC has shown it's ability to earn 1.7%-1.8% return on asset despite declining NIM and long term interest rates. If long term rates don't continue to decline too much and housing starts to turn, it would not be a stretch to imagine WFC doing very well.

Anyway, it looks like NIM declines are not necessarily driven by the yield curve but by lower long term interest rates. The yield on earning assets have declined partly due to lower long term interest rates and also due to a declining spread on loans, but this seems to be due to asset mix/loan quality issues rather than declining spreads due to competition between lenders. Much lower portion of the loan portfolio going into consumer loans is a big factor.

So anyway, we are back to what we knew in the first place; WFC is doing pretty good in this awful environment but can do really well if housing/economy really does pick up (and if consumer loan demand goes up). If interest rates stay down here, WFC can actually still do well, just not great.

But if long term interest rates continue to decline and housing doesn't recover, then that will be a problem; WFC may end up having to put more of their deposits into low yielding Treasuries and that would not be so great. That would be like the Japan scenario, even though I would think that WFC management would respond more quickly to such a scenario and not just sit there and hope.