

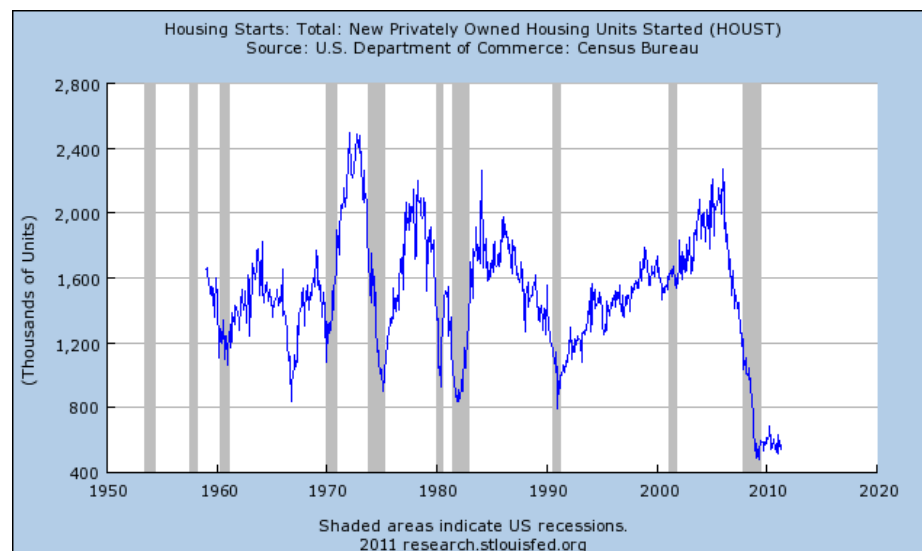


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It appears that the economic recovery is being stalled by a problematic conundrum – the unemployment rate is having trouble improving given weakness in housing, and housing is having trouble improving given weakness in unemployment. To be sure, we do not know when a housing recovery will take hold. Volumes and especially prices may face pressure for an extended period of time. What is the solution? Short of drastic policy responses, such as demolishing current housing inventories or aggressively restructuring household mortgages, the answer is *time*. Warren Buffett explained in early 2010:

In 2009, [housing] starts were 554,000, by far the lowest number in the 50 years for which we have data. Paradoxically, this is good news. People *thought* it was good news a few years back when housing starts – the supply side of the picture– were running about two million annually. But household formations – the demand side – only amounted to about 1.2 million. After a few years of such imbalances, the country unsurprisingly ended up with far too many houses. There were three ways to cure this overhang: (1) blow up a lot of houses, a tactic similar to the destruction of autos that occurred with the “cash-for-clunkers” program; (2) speed up household formations by, say, encouraging teenagers to cohabitate, a program not likely to suffer from a lack of volunteers or; (3) reduce new housing starts to a number far below the rate of household formations. Our country has wisely selected the third option, which means that within a year or so residential housing problems should largely be behind us, the exceptions being only high-value houses and those in certain localities where overbuilding was particularly egregious. Prices will remain far below “bubble” levels, of course, but for every seller (or lender) hurt by this there will be a buyer who benefits.<sup>1</sup>

While Buffett repeated his prediction for a housing recovery within a year again in early 2011,<sup>2</sup> he might be considered bullish compared to consensus. Robert Shiller, an economist at Yale University and one of the designers of the Case-Shiller Home Price Indices, recently stated in an interview that he had not seen any signs of recovery and continuing price declines would not surprise him.<sup>3</sup> To date, new housing starts continue to limp along and it will require sizable gains to get back to anything close to a normalized run-rate:



<sup>1</sup> Annual letter to Berkshire Hathaway shareholders, Warren Buffett, February 26, 2010.

<sup>2</sup> Annual letter to Berkshire Hathaway shareholders, Warren Buffett, February 26, 2011.

<sup>3</sup> US Home Prices Could Still Fall a Lot More: Shiller, Reuters, June 9, 2011; <http://www.cnbc.com/id/43339262/>.

We are confident in saying that we don't know when the housing market will stabilize or what a "normal" level of prices will turn out to be. We also don't know what kind of trend prices will assume once they have bottomed. However, we do believe that (a) the housing market *will eventually stabilize* and (b) when it does, housing starts should reflect new household formation (~1.2-1.6 million per year).

Housing-related issues have had much different effects on different sectors of the stock market. Investors in the general stock market have mostly regained their post-peak losses. Investors in banking- and building-related stocks, however, are not close to even:<sup>4</sup>

Investment	Date of Peak	Return from Peak	Benchmark
Stock Market	Oct-07	-7.0%	S&P 500
Residential Real Estate	Aug-06	-32.8%	Case-Shiller 20-City HPI
Banking Sector Stocks	Feb-07	-55.6%	iShares DJ US Financial Services
Building Sector Stocks	Apr-06	-56.3%	SPDR S&P Homebuilders

To be sure, some of the losses borne by banking and building investors will turn out to be permanent – not only were valuations during peak years stretched and based on unsustainable activity, the subsequent balance sheet restructurings taken by constituent companies, including the issuance of equity to offset losses, will result in the permanent impairment of value. But after 4-5 years of horrific difficulties and recapitalizations, the two sectors are still largely unloved by both professional and retail investors. Much like the frog who sat on the hot stove, many investors refuse to touch the sectors again.

Recently we have written that we are not enamored with the current set of investable opportunities. While we do not believe that the stock market is overvalued, we do not believe it is undervalued. Further, any talk of a "secular bull market" like that seen in the 1990's strikes us as misguided – bull markets typically start with (a) high interest rates (that subsequently fall) and (b) low price-to-earnings (PE) ratios, neither of which are present today. So while we feel comfortable with our current stock holdings, investors may not be able to earn the kind of returns in the stock market needed to offset low potential returns in the bond market to create overall portfolio returns in-line with historical expectations.

<sup>4</sup> Bloomberg Financial Data. The stock market figures (S&P 500, iShares DJ US Financial Services and SPDR S&P Homebuilders) are through May 31, 2011; the real estate figures (Case-Shiller) are through April, 2011. The stock market figures include dividends; the real estate figures do not include dividends (i.e. rental payments). None of the returns assume any leverage was employed.

But we always tell our clients that we are "bottom-up" investors – what does that mean? It means that we don't look at macroeconomic data such as interest rates, housing starts or global PE ratios to determine our investment allocations. Instead we closely follow individual companies and investments, becoming bullish when our analyses lead us to the conclusion that such businesses are trading at wide discounts to what we calculate as their "intrinsic values." We literally maintain a large spreadsheet of companies that we have studied, feel we understand and would feel comfortable purchasing at the right price. This spreadsheet tracks *price-to-fair value ratios*, or the difference between the current stock price and our calculation of the stock's true worth.

While much of our hopper suggests a stock market slightly undervalued to fairly valued, we are starting to see some opportunities in those unloved sectors – banking and building. We often find that adversity brings opportunity, and great investors like Warren Buffett have made a good deal of their fortunes working in forsaken sectors of the market. Whenever investors, en masse, refuse to invest in certain industries regardless of price, opportunity likely resides. Accordingly, we have been researching the challenges faced by the banking and building sectors and calibrating our valuation models. While the two sectors no doubt continue to face a host of difficult-to-gauge challenges and prices will likely continue to be volatile, at least over the short-term, prices appear to us to be at or near levels that present investors with potentially attractive risk-adjusted returns.

First, the challenges...

Banks have been confronting perhaps their most difficult operating environment since the Great Depression. While the last couple of years have brought some relief, difficulties still abound:

- Recent laws will limit the amount of money that banks can make on a host of products, including checking and savings accounts, debit and credit cards and trading products. While we believe that banks will find ways to offset at least a portion of the revenues lost, it will likely be difficult to find ways to effectively charge for all of the explicit and implicit costs required to provide these products.
- In response to the financial crisis, global regulators are rewriting the rules for banks. Chief among the changes are more onerous capital requirements; in other words, banks will be forced to run at much

lower levels of leverage. While this no doubt reduces risk in the banking sector (and seems to be a prudent move), there is the threat that (a) regulators go too far and require capitalization levels that are too high and (b) regulations will be differentiated between small and large banks or more worrisome domestic and international banks, leading to unintended competitive impacts. Regulators will require “systematically important financial institutions” (SIFIs), such as JP Morgan and Bank of America, to carry an extra capital buffer relative to smaller banks. Even if regulators effectively deal with these issues and despite lower systemic risk, higher capitalization rates, while not effecting normalized earnings, will affect the rate at which banks can *grow* their earnings (lower leverage = lower potential growth rates).

- We have written for some time that the domestic economy is in a “deleveraging” environment. The recent financial crisis was caused by overleveraged consumers that are subsequently, and rationally, operating in debt-retrenchment mode. Large banks earn approximately half of their revenues from lending activities. An environment where savings outpaces loan demand leads to low interest rates and a runoff in bank loan portfolios. Banks earn a net interest margin on their lending activities – the difference between the rate they earn on their assets and the rate they pay on their liabilities. Both the net interest margin and loan balances have been contracting, pressuring lending revenue. This headwind will likely persist for some time. Following Japan’s financial crisis in the late 1990’s, loan balances contracted ~25% and net interest margins contracted ~15% over a period of approximately eight years.<sup>5</sup>
- Banks continue to post losses on falling housing prices. These losses come not only from the banks’ inventory of mortgages and real-estate related loans but also from litigation charges on products originated by banks and sold to investors during the peak of the market bubble. For instance, Bank of America sustained \$46 billion in housing-related losses from the first quarter of 2008 to the first quarter of 2011, and one analyst expects that the bank could face another \$27

billion in housing-related losses through 2013.<sup>6</sup> Further weakness in housing prices could lead to even greater losses. If losses are much larger than expected, under-capitalized banks may be forced to once again raise equity, diluting the existing shareholder base.

- The financial crisis revealed to investors that banks were susceptible to systemic risk, meaning that even if a certain bank appeared healthy, their entanglement with the rest of the financial system could render it at risk during a market meltdown. Banks operate with large balance sheets containing a multitude of assets that carry counterparty risk; understanding and accounting for that risk can be difficult.

Building-related stocks face much more basic, though no less challenging, issues. In some cases, companies that manufacture or sell products related to residential or commercial construction (i.e. drywall, cabinets, plumbing fixtures, pipes, etc.) have experienced sales declines upwards of 50% from peak years (2005 and 2006), resulting in negligible or negative cash flows. In response, many of these companies have rationalized their manufacturing footprint to cope with lower volume relative to that seen at the top of the housing bubble. Increasing commodity costs have pressured already thin profit margins. In cases where the company also depends to some degree on real estate price appreciation (e.g. homebuilders), the pain has been even worse. One building products company that we follow is operating at just 50% of their manufacturing capacity, which has been meaningfully reduced from peak capacity levels.

Given these intense challenges, why should investors consider committing any capital to these sectors? For the following reasons:

- Despite current headwinds, some firms in these sectors operate attractive business franchises. For example, large global banks like JP Morgan Chase, Wells Fargo and Bank of America have enviable retail franchises that command nearly \$1 trillion in stable, low cost deposits each and have the opportunity to cross-sell a host of services to rather sticky customers. Certain building products manufacturers, retailers and sometimes even homebuilders are able to generate attractive returns on capital because of local economies of

<sup>5</sup> Lower rates mean lower profits for longer, Goldman Sachs Equity Research, August 18, 2010.

<sup>6</sup> Bank of America: Dimensioning the Housing-Related Risks, BernsteinResearch, June 13, 2011.

scale. Both sectors are comparatively insulated from international competition.

- While it took 4-5 difficult years to get there, many financial services companies and building-related companies now have clean, attractive balance sheets. The banking sector boasts some of the best capitalization rates in decades.<sup>7</sup> Building-related companies have worked hard to rationalize assets and conserve cash; many now have cash assets that exceed their current debt outstanding. This significantly reduces the risks of investing in the sectors relative to previous periods. Companies can now afford to be patient and wait for a change in end market activity.
- The severe operating environment has forced these companies to cut fat and optimize their businesses. For instance, many building-related companies should be able to generate meaningful cash flows at lower levels of end market activity than before. At banks, current earnings are significant but overshadowed by continuing housing- and litigation-related losses, which will eventually subside.
- Most importantly, the stocks are *cheap*, even after making conservative estimates regarding stabilization in the housing market and accounting for the numerous risks threatening the business models. Risk is directly related to price. What is risky at one price is safe at another price, assuming the probability of capital impairment is judged to be negligible. For example, we recently initiated positions in a banking- and building-related stock, respectively. We expect that in a “normalized” environment, the two stocks could each earn around ~\$2.25 per share. The stocks were purchased at around \$10.50 and \$12.00, respectively. Now assume that (a) it takes four *more* years for near-term challenges to subside and normalized earnings to materialize and (b) at the end of those 4 years, the stocks trade at PE multiples of 10.0x and 12.0x respectively, below long-term averages. Even under this conservative scenario, the two stocks would generate annual returns of 21% and 22%. If these estimates turn

out to be in fact aggressive, we still have a significant buffer (what we call our “margin of safety”) that would allow us to generate acceptable returns in a worse than expected scenario – if a normalized environment took eight years to materialize, annual returns would still be 10% and 11%.

Please note that this memo is not a recommendation to buy or sell any securities. This is also not a “sector call” – we are simply stating that we believe there are quality businesses for sale at attractive prices that happen to be engaged in building and banking activities. It should also be noted that even if we are correct in our estimates, the short-term ride could be very bumpy – the stocks of these companies have exhibited above-average volatility and they will likely move significantly based on surprises in economic data. But we believe that over the long-term shareholders will be rewarded for their patience.

We do not believe in “closet indexing” – matching our industry weights to those of the benchmark that we measure ourselves against. We instead buy businesses that (a) we understand, (b) have compelling economics and (c) are priced at attractive levels, regardless of industry weightings. While this may lead to uncorrelated movements in our portfolio relative to the benchmark over shorter time periods, we believe that longer-term it should provide superior returns.

We are starting to selectively build investment positions around this thesis, though it is possible that the stock prices move up to ranges above our desired buy prices before we can establish a meaningful allocation (we typically take some time to scale into a given position); some of the stocks that we have been monitoring have illustrated moves of 10-15% in a matter of just a few days.

The past two years have been relatively kind to investors (albeit it after an extremely rough patch in 2008-2009) – rising water has lifted all boats. Going forward, we believe that stock-picking will become more important. So while we are cautious regarding investment markets as a whole, we hope to find attractive investment opportunities through our bottom-up research efforts. As always, we thank you for your continued confidence.

<sup>7</sup> According to Goldman Sachs, large cap banks currently hold an average Tier 1 ratio of 12.6%, significantly above the previous high for the period 1991-present of ~10.6%. *Assessing the problem with bank stocks*, Goldman Sachs Equity Research, April 25, 2011. Further, Jamie Dimon, CEO of JP Morgan Chase, points out that bank balance sheets are much cleaner than they have been in some time. *Chairman and CEO Letter to JP Morgan Shareholders*, Jamie Dimon, April 4, 2011.