Banks: Expensive at Every Price

We're not in the habit of making heretical statements, but we believe banks are not an appropriate investment at any price for the thoughtful value investor. Let us put the case forward.

Banks don't make any profits. This point won't come as any surprise to those that have read Nassim Taleb's *Fooled by Randomness*. In the book Taleb describes the Latin American debt crisis in the early 1980s, which cost large US commercial banks more than the cumulative profits they had ever made up to then. This was shortly followed by the US Savings & Loans crisis, which lasted from the mid-80s and into the 1990s, when an extraordinary 750 institutions failed (at an estimated cost of $90bn). It's a similar story in Asia. Between 1980 and 2002, 14 banking crises cost on average 22% of GDP (the 1997 crisis cost Indonesia a whopping 55% of GDP). And again during the recent Global financial crisis, which the IMF estimated cost $2.3trn – a figure that would undoubtedly have been many times higher if not for the dramatic and unprecedented actions of global Central Banks. While no one can be certain of what the future holds, it would be very surprising if such events do not repeat themselves in the future – the weight of historical evidence would suggest so.

Shareholders in banks exist at the mercy of governments and Central Banks. Governments have a vested interest in keeping the banking system 'healthy' (let's face it, a contracting banking sector is hardly a vote-winner). To that end, banks' shareholders are greatly subsidised. Their 'size zero' equity buffer is supposed to fill depositors with confidence that they can absorb loan losses. History has shown such buffers to be hopelessly inadequate at times of crisis. So governments *must* explicitly or implicitly stand behind deposits, while Central Banks *must* be there as a lender of last resort. Without these props banks would at all times be at the risk of a deposit run, an event that would force banks to quickly sell assets at discount prices which in turn would wipe out their equity. You could say that banks' equity is an illusion. No other industry receives such advantageous support.

Mervyn King, head of the Bank of England, gave a speech in October 2010 at *The Economist*'s Buttonwood gathering in New York. He spoke with quite extraordinary frankness, given his position at the epicenter of the finance world. *"Of all the many ways of organising banking, the worst is the one we have today".* As far as we know, his "confession" was not given under duress! Firstly, he said, short-term deposits fund risky long-term assets, leaving banks perennially exposed to liquidity risk. Secondly banks are highly leveraged, meaning that small changes in asset values dramatically impacts equity. In his speech he lamented how there had been a gradual but definite weakening of the financial system globally over the last 50 years, through on- and off-balance sheet antics. He was scathing of the attempts of Basle I, II and III rules to put right the system's core weaknesses (rules that appear about as instructive as Rocky I, II and III). King suggested some solutions – requiring better maturity-matching and much, much higher capital per unit of asset. Also touted was a system whereby loans are packaged and sold

to investors. It would work in much the same way as mutual funds; individuals would own shares in a collection of loans, which they could sell in the secondary market. This would eliminate the maturity mismatch problem. The advantage of this approach is that it would separate lending activities from the money transmission mechanism that governments and Central Bankers rightly wish to protect at all costs. While these solutions have merit, the cost of loans would be dramatically higher (and their availability likely dramatically lower), a position society might not be willing to accept. Besides, getting from here to there would be a road fraught with danger. As the Kerry man said when asked directions, *you wouldn't start here*. Those with even half an interest in the difficulties facing the banking industry are urged to read Mervyn King's speech[1].

Let's examine Barclays as an example. The UK bank is a global financial powerhouse these days, one that withstood all that the recent financial crisis could throw at it. However, its equity is 26 times levered – if the value of its assets were out by less than 4% then shareholder's interest in the bank would be no more. Borrowing from Ben Graham, an investment based on such refinement of asset valuation offers no 'margin of safety'.

Barclays was steered through those choppy waters by John Varley and Bob Diamond. Varley retired as chief executive in late-2010, job well done, and was succeeded by the bank's Investment Banking head, Bob Diamond. Diamond (in fairness, a great surname for a CEO), up there with J.P. Morgan's Jamie 'The Rock Star' Dimon, is now seen as a poster boy of competent bank management, his new-found celebrity status propelling him from the pink of the Financial Times to the glossy of magazine covers. While there has been public anger over the size of Varley's and Diamond's bonuses, there have been plenty of nods of approval for their business acumen.

Diamond recently testified in front of the House of Commons Treasury Select Committee. He spoke aggressively, from the front foot. Among his memorable comments were that the *"time for banker remorse is over"*, *"Banks should be allowed to fail"* and *"It's not okay for taxpayers to have to bail out banks"*. In other words, weak banks with weak managements have been found out, leave the successful ones to get on with the Lord's work. Big talk from one so sure-footed. So are John Varley and Bob Diamond genuine heroes?

Or perhaps lucky villains – lucky that Barclays' proposed takeover of ABN in 2007 (which Varley and Diamond spearheaded) did not bury them! For those that need reminding, Barclays attempted bid was pipped at the post by a tag team of RBS and Fortis, both of whom subsequently had to rely on the kindness of their respective governments for survival (their equity holders fared less well). Had Barclays won that bid they surely would have suffered a similar fate, making Diamond's Treasury Select Committee comments all the more galling.

Perhaps *villains* is being too harsh. Didn't Barclays buy Lehman right at the bottom of the market, a move that has generated fantastic value for shareholders? According to a New York Times article around about the time of the deal, Lehman had two million interest rate swaps when purchased, not to mention all the other derivatives and convoluted assets. This deal was hammered out over a weekend, far too little time to properly assess the equity value of Lehman. It's hard not to conclude that the Lehman deal was a lucky – not a skilful – roll of the dice. Since then the value of Lehman has since gone up substantially. We live in a results driven world, which over-emphasises outcome and totally neglects the risks that Barclays undertook. Barclays management hit a home run, but could so easily have been struck out with such a wild swing of the bat. Anyone need reminding about what happened previously strong Lloyds following their ill-fated purchase of HBoS?

The obvious retort to all this is that the message comes a bit too late – we've already *had* the crisis. Won't it be 20 years or more before the next crisis hits, over which time banks will have made a mountain of profit and their share prices been propelled much higher? Yes, admittedly that's a distinct possibility. But banks are like time bombs with faulty clocks – you can never tell when they will blow up. To use Taleb, it's like picking up pennies in front of a steamroller with a Ferrari engine and a psychotic driver.

The interesting thing is that some of the world's best-known value investors own shares in banks, including Warren Buffett and Bruce Berkowitz. One must bow to their investment intellect but it really is tough to grasp what they see in these investments. Then again, how many investors can pick up the phone to (the then US Treasury Secretary) Nicholas Brady when one of their bank stocks gets into trouble (as Buffett did in 1991-92 as Chairman of Solomon). Besides, Buffett is only too well aware of the risks, given his chastening experience in 2008 with the two Irish banks, AIB and Bank of Ireland.

Surely value investor Bill Miller of Legg Mason now 'gets it' also. Without wishing to rain on Miller's parade at a time when his star has somewhat faded, his experience through the recent crisis is a salutary lesson for us all. It's well described in Michael Lewis' book *The Big Short*. In March 2007 Bill Miller was invited to speak at an investor conference hosted by Deutsche Bank. At the time he owned $200 million of Bear Stearns stock and he spoke positively on the stock, right about the time the bank announced that it had been the subject of rumours regarding its liquidity. An hour later the stock had almost halved from $53 to $29 a share. A question from the floor: *"Mr. Miller, from the time you started talking, Bear Stearns stock has fallen by more than twenty points. Would you buy more now?"* Miller had no clue what was going on and said *"Yeah, sure, I'd buy more here".* Two days later Bear Stearns was sold to J.P. Morgan for $2 a share (later revised to $10 a share).

Banks are very important from a societal viewpoint. Therefore their franchises will in all probability be preserved come what may (particularly the 'too big to fail banks' which over the course of the crisis grew into 'even bigger too big to fail banks'). But that says nothing about how equity owners will fare. Perhaps governments will not be as generous in the next crisis. This is a huge question with no answer. In such a vacuum who can get comfort?

And you'll notice that this article doesn't mention price or valuation once. It's possible – perhaps probable – that banks are expensive AT EVERY PRICE! Or, somewhat more generously, banks should be viewed and valued as out-of-the-money options – likely worthless (generate no earnings as a sector; illusory equity capital), but potentially worth a lot. Of course there will be exceptions (don't they prove the rule?), but this does not change the article's main thrust – the bank <u>sector</u> looks grossly overvalued for the risks assumed.

Bank stocks are for passive and for closet-index funds (given the sector's high weight in equity benchmarks). Value investors with a capital preservation mandate should view them with extreme suspicion.

If bank stocks are the best investments you can find for your portfolio, you should fear for your (or your clients') wealth.

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