The Financial Sector

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Cougar Investment Fund
Introduction - Financial Sector

- The financial sector consists of investment banking firms as well as large commercial banks.

- The ticker symbol is XLF


- Total of 81 companies represented in the sector
The leading industries within the sector are Insurance, Commercial Banks, and Diversified Financial Services.

The current average price per share in the sector is $15.16.

Last time it was the highest weighted sector was in 2005 with a weight of 21.2 this coincided with the economic boom from 2005 to late 2007.
**Financial Sector Overview:**

<table>
<thead>
<tr>
<th>Financial Sector</th>
<th>Total Market Cap (Billions)</th>
<th>Return on Equity TTM</th>
<th>P/E TTM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Captial Markets</td>
<td>$579.30</td>
<td>8.83%</td>
<td>19.62</td>
</tr>
<tr>
<td>Commercial Banks</td>
<td>$2,100.00</td>
<td>10.12%</td>
<td>11.02</td>
</tr>
<tr>
<td>Consumer Finance</td>
<td>$139.40</td>
<td>21.54%</td>
<td>11.68</td>
</tr>
<tr>
<td>Diversified Financial Services</td>
<td>$476.60</td>
<td>-20.74%</td>
<td>10.89</td>
</tr>
<tr>
<td>Insurance</td>
<td>$934.00</td>
<td>9.37%</td>
<td>11.87</td>
</tr>
<tr>
<td>Real Estate Investment Trusts</td>
<td>$645.40</td>
<td>6.72%</td>
<td>87.76</td>
</tr>
<tr>
<td>Real Estate Management &amp; Development</td>
<td>$101.20</td>
<td>9.63%</td>
<td>34.9</td>
</tr>
<tr>
<td>Thrifts &amp; Mortgage Finance</td>
<td>$56.90</td>
<td>5.16%</td>
<td>25.9</td>
</tr>
<tr>
<td><strong>Totals/Average</strong></td>
<td><strong>$5,032.80</strong></td>
<td><strong>6.33%</strong></td>
<td><strong>26.705</strong></td>
</tr>
</tbody>
</table>

Total Market Valuation = $5.03 Trillion
Recent Performance:

The financial sector has outperformed the S&P 500 over the past year by 3.83%
Top 20 Largest Equities of Financial Sector:

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Symbol</th>
<th>Security Type</th>
<th>Sector</th>
<th>Market Capitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>WELLS FARGO &amp; CO</td>
<td>WFC</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$187.2B</td>
</tr>
<tr>
<td>HSBC HOLDINGS PLC</td>
<td>HBC</td>
<td>Depository Receipt</td>
<td>Financials</td>
<td>$172.4B</td>
</tr>
<tr>
<td>JPMORGAN CHASE &amp; CO</td>
<td>JPM</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$156.7B</td>
</tr>
<tr>
<td>BERKSHIRE HATHAWAY INC.</td>
<td>BRK/A</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$123.3B</td>
</tr>
<tr>
<td>CITIGROUP INC</td>
<td>C</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$99.5B</td>
</tr>
<tr>
<td>BANK OF AMERICA CORP</td>
<td>BAC</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$99.5B</td>
</tr>
<tr>
<td>BERKSHIRE HATHAWAY INC.</td>
<td>BRK/B</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$96.3B</td>
</tr>
<tr>
<td>ROYAL BANK OF CANADA</td>
<td>RY</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$83.6B</td>
</tr>
<tr>
<td>BANCO SANTANDER SA</td>
<td>SAN</td>
<td>Depository Receipt</td>
<td>Financials</td>
<td>$77.5B</td>
</tr>
<tr>
<td>WESTPAC BANKING CORP</td>
<td>WBK</td>
<td>Depository Receipt</td>
<td>Financials</td>
<td>$77.3B</td>
</tr>
<tr>
<td>TORONTO-DOMINION BANK (THE)</td>
<td>TD</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$76.5B</td>
</tr>
<tr>
<td>MITSUBISHI UFJ FINANCIAL GROUP</td>
<td>MTU</td>
<td>Depository Receipt</td>
<td>Financials</td>
<td>$69.9B</td>
</tr>
<tr>
<td>AUSTRALIA &amp; NEW ZEALAND BANKING GROUP LTD</td>
<td>ANZBY</td>
<td>Depository Receipt</td>
<td>Financials</td>
<td>$67.6B</td>
</tr>
<tr>
<td>AMERICAN EXPRESS CO</td>
<td>AXP</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$66.5B</td>
</tr>
<tr>
<td>U.S. BANCORP</td>
<td>USB</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$64.8B</td>
</tr>
<tr>
<td>BANK OF NOVA SCOTIA (THE)</td>
<td>BNS</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$64.7B</td>
</tr>
<tr>
<td>BNP PARIBAS</td>
<td>BNPQY</td>
<td>Depository Receipt</td>
<td>Financials</td>
<td>$63.6B</td>
</tr>
<tr>
<td>NATIONAL AUSTRALIA BANK LTD</td>
<td>NABZY</td>
<td>Depository Receipt</td>
<td>Financials</td>
<td>$58.2B</td>
</tr>
<tr>
<td>GOLDMAN SACHS GROUP INC (THE)</td>
<td>GS</td>
<td>Common Stock</td>
<td>Financials</td>
<td>$57.5B</td>
</tr>
<tr>
<td>ALLIANZ SE</td>
<td>AZSEY</td>
<td>Depository Receipt</td>
<td>Financials</td>
<td>$55.7B</td>
</tr>
</tbody>
</table>
“S&P recommends marketweighting the S&P 500 Financials sector. Year to date through August 24, the S&P Financials Index, which represented 14.4% of the S&P 500 Index, rose 16.1%, versus a 12.2% gain for the S&P 500 Index. In 2011, this sector index fell 18.4%, versus a flat showing for the 500. There are 20 sub-industry indices in the sector, with Other Diversified Financial Services being the largest at 17.3% of the sector's market value.” – Standard & Poor’s Sector Commentary (September 16, 2012)

Examples of diversified financials include: JPMorgan, Bank of America, Citigroup etc.
Sensitivity to macroeconomic shifts

- Financial Sector is historically extremely sensitive to changes in macroeconomic factors
  - Interest rate sensitive
  - Inflation sensitive
  - Other factors
Historic Sensitivity

- Have been the most sensitive sector historically
- In 1970's financial sector performed the very poorly during periods of high inflation
Volatility compared to S&P 500

-Sensitivity to interest rates, inflation and other macroeconomic events make the financial sector a historically volatile stock compared to the market as a whole

-From September 4th to September 19th, S&P gained 3% while XLF gained 5.5%
Historical Outlook: 1998 - Present

[Image of a financial chart showing stock performance from 1999 to 2012, with the financial Select Sector SPDR (XLF) stock price history.]
In comparison with S&P 500
Financial Sector and the Business Cycle

Cyclical Sector
- Stock Beta's > 1
- Prosperous in expanding economy

Banks
Financials
Insurance
Real Estate
Financial Product Lifecycle

- Financial Products Have Life-Cycles too

- Where is the Financial Sector as a whole?
Financial Crisis

- Subprime mortgage crisis
- Defaulted loans
- Credit Default Swaps ($62 trillion market)
- Hit the banking industry hard
- Financial sector bailouts

AIG’s risk exposure from credit default swaps on Feb. 28, 2008.
- would wind up defaulting on $14 billion worth of credit default swaps
Financial Crisis

- AIG: $85 billion bailout from the U.S. Federal government
- Lehman Brothers collapse
  - Feb. 2007: Stock traded at $86.18
  - Market Cap: $60 Billion
  - 4th largest investment bank
- Sept. 15, 2008: Declares bankruptcy
Financial Crisis

-Sep. 21, 2007; S&P 500: 1525.75, FIN: 464.45
-Lowest point for S&P 500 and FIN index
-S&P 500: decreased 55%
-FIN: decreased 82.4% (27.4% difference)
Recent Macroeconomics Variables:

• Unexpected slowdown in loan growth has well positioned U.S. banks to perform steadily through year end.

• Recovery of bond and equity markets pushed 2012 Q1 results slightly higher than originally anticipated.

• Revenue growth fell slightly short of expectations in Q2, which was blamed on a decelerating economy.
Recent Macroeconomic Variables:

Short-term factors affecting uncertainty:

- Frugal federal spending
- On-going European crisis
- Tax law uncertainty (U.S. election year)
Impact of the federal government:

• Increased federal spending may stimulate growth in the financial sector.

• At times, the federal government may use taxpayer money to anchor big banks.
  - Ex. Troubled Asset Relief Program (TARP) in October of 2008.
  - Authorization to spend over $450 billion of taxpayer money.
Current european economic crisis:

• Financial crisis resulting from many eurozone countries being unable to refinance their debt.

• Some of the most financial unstable european countries include: Greece, Portugal, Cyprus, Spain, Slovenia, Ireland and Italy.
Countries using Euro currency:

- Europe contains four of the top ten largest economies ranked by nominal Gross Domestic Product (GDP).
European Interest Rates:

- Low credit ratings create high interest rates.
- Higher interest rates make it difficult for unstable countries to refinance their debt.
Meeting financial obligations:

• Some countries are able to create more of their own currency in order to meet financial obligations:
  ▪ United States
  ▪ Japan
  ▪ China

• Meanwhile, the Euro is created and issued by the Institutions of the European Union participating in the Eurozone.

• Therefore, financial unstable countries are required to seek financing to stay afloat.
What does this mean for financials?

• Derivatives for U.S. banks are valued differently in the United States than they are in Europe creating a discrepancy in overall market valuation.

• Almost all large U.S. based banks are heavily invested in European countries.

• Therefore, a financial crisis in Europe has a direct effect on U.S. financials.
Effects of a U.S. election year:

U.S. Gross Federal Debt as a Percentage of GDP
Basic economic views for election:

• Democratic President:
  o Large government
  o Increased taxes on high wage earners

• Republican President:
  o Smaller government
  o Less taxes to benefit the overall economy

• Different presidential outcomes have different effects on the tax rates.
• Tax rates greatly influence financial sector performance.
Macroeconomics: Looking Forward

• The financial sector will not be returning to its pre-recession peaks anytime soon.

• Economic boom of past decade was greatly spurred by the financial sector.

• Almost all large banks were involved in overly generous residential/commercial mortgage lending as well as artificial asset valuations.

• Residential and commercial real estate lending is now highly regulated (conservative).
Some U.S. banks are looking to profit from the Eurozone crisis in the short term.

If capital is invested wisely, some large U.S. banks may be able to generate large long term capital gains resulting from Euro pitfalls.

U.S. banks benefited from loan growth over 10 straight months, though it recently began to decline as of July 2012.
Potential Increased Regulation:

• The financial sector has seen a large amount of increased regulation from the recent financial crisis.

• Several other regulatory requirements are anticipated in the near future.

• Regulatory requirements typically hinder growth of United States banks.
Commonly used valuation matrixes

- **P/E ratio**: The ratio of price per share to earning per share
  - **Market Value per Share**
  - **Earnings per Share (EPS)**
XLF Sector

• Current P/E ratio is 12 (yahoo finance)
• Indicator for growth opportunities of the sector.
• Sector Constituents P/E ratio
  – Wells Fargo & Co (WFC) 11.72
  – JP Morgan Chase (JPM) 9.54
  – Chicago Mercantile Exchange (CME) 12.33
  – All State Corp (ALL) 9.7
• Only useful to compare companies in the same industry.
Historical XLF P/E Ratio
Problems/Relevancy

• Arbitrary accounting rules set by GAAP
• Understated inventory and depreciation cost costs during high inflation times.

Relevancy

• Use multiple ratio analysis and matrixes to determine the value of sectors or stocks.
  – P/S
  – P/B
  – P/FCF
  – ROE
Sources

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