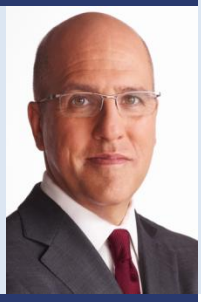

Richard Bernstein

Richard Bernstein Advisors

Why smaller banks are attractive

June 1, 2012

Why smaller banks are attractive

We continue to prefer smaller, US domestic banks to larger, multinational banks. A backdrop of anemic yet improving US employment and stabilizing housing markets will likely benefit domestic lenders, but the continued deflation of the global credit bubble could continue to hurt the growth prospects for global financial institutions. Although the vast majority of the risks related to the deflation of the US credit bubble seem well-known, investors still appear to be underestimating the risks of credit deflation in Europe and in the Emerging Markets. It seems as though the managements of global financial institutions are making the same forecasting error.

We have argued for four years that investors should perhaps begin to overweight global financial companies when regulators forced these institutions to shrink their balance sheets, and the firms once again focused on low-return businesses related to traditional capital formation. These events clearly have not yet happened.

Wall Street analysts still generally disagree with our views. Although earnings growth assumptions for multi-national financials have been reduced, analysts' forecasts still seem overly optimistic given the combination of a backdrop of global credit deflation and the firms' continued focus on non-traditional lending and trading for growth.

The current discussion regarding financial regulation seems to be side-stepping some important points that are critical to the future vibrancy of the US financial system. We feel it is inevitable that these issues surface and constrain both large bank profitability and the performances of their stocks.

1. If the recent problems at a large bank's trading desk had been bigger, would the Fed and the US taxpayer have been required to bail out the bank for a trade in non-US investments made outside the US? Why is it the US's obligation to support banks for their non-US dealings?

2. Large banks now sometimes house their derivatives in their US national association ("NA"), where deposits are insured. This is done because the NA often has a higher credit rating than does the parent multi-national corporation, which makes the NA a better counter-party than might be the parent. The FDIC has argued against allowing this, but why isn't Washington more concerned that US deposits are sometimes being used as collateral for non-US derivatives?

Richard Bernstein
Advisors LLC
520 Madison Avenue
28th Floor
New York, NY 10022
212-692-4000

www.rbadvisors.com

3. The most prudent form of risk management has always been to assess whether the risk/return characteristics of a position are favorable without hedging. If hedging is needed, one should ask why the original position was put on the balance sheet in the first place. Of course, such conservatism curtails lending, but it helps ensure more efficient capital allocation in the overall economy because it forces banks to assess the correct hurdle rates for their investments.

4. The problem, in our view, isn't really the size of the larger banks; it is that the larger banks have moved away from traditional lending. For example, larger banks would these days prefer buying corporate bonds for capital appreciation than making corporate loans for income.

5. Banks are traditionally income investors, and not total return investors. If the larger banks want to be total return investors, then let them become uninsured investment banks with lower credit ratings. It is not the US taxpayers' obligation to ensure that banks can compete with investment banks. To us, that is the simple underlying economic and political issue.

The easy-money policies of the Greenspan-era Fed coupled with the repeal of the Glass-Steagall Act led banks away from their traditional income-oriented sources of return toward more risky, capital appreciation-oriented sources of return. Accordingly, the larger banks were some of the biggest beneficiaries of the global credit bubble, but that bubble is now deflating. It may be prudent to avoid the larger banks until they return to their traditional income-oriented roots.

In the meantime, smaller US banks generally have strengthening balance sheets, and continue to aid US capital formation. Admittedly, traditional banking typically has lower profitability ratios (and can be rather boring!), but smaller US banks don't need massive trading infrastructures and unnecessary global risk-taking to be profitable. They understand the credit bubble is deflating. The larger banks have yet to fully grasp that fact.

We have long been champions of income-oriented investments. Traditional banking was built on such income-oriented strategies. It's our guess that the larger banks will slowly return to their income-oriented roots. Until then, multi-national bank stocks are likely to secularly underperform.

Richard Bernstein
Advisors LLC
520 Madison Avenue
28th Floor
New York, NY 10022
212-692-4000

www.rbadvisors.com

Richard Bernstein Advisors

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Richard Bernstein
Advisors LLC
520 Madison Avenue
28th Floor
New York, NY 10022
212-692-4000

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