Pzena Commentary

Fear trumps fact in the short run. To discount the financial sector as much as it has been means you have to assume the industry is permanently impaired. It's not.

Valuations for leading financial firms are no longer rational, as investors have lost sight of the earnings power of these businesses. A risk to equity holders of dilution does exist – but the risk of bankruptcy or a dramatic decline in earnings power is being vastly overstated by the markets. We believe this provides an exceptional opportunity to buy the leading firms at distressed prices. Specifically, we believe the following three points will prove to have been obvious once we look back on this environment:

- Contrary to prior financial cycles, accounting rules are front-loading losses and potentially leading to overstating them.
- The risk of failure is not significant for most leading financial companies.
- The future earnings power of many financial firms is not materially impaired despite the possibility of deleveraging.

As always in equity investing, stock selection will be the key, and we believe that some financial firms may become insolvent during this downturn. Still, the opportunity in the financial sector broadly, and among the industry leaders specifically, has become extreme, and taking advantage of such circumstances is exactly what value investors do.

Marking to Market Can Be Misleading

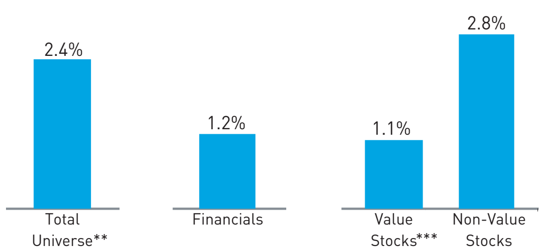
The often massive losses reported by many financial firms, leading to capital raises and dilution, have led to concerns that the entire industry is permanently damaged. Yet much of the losses are due to new accounting regulations that did not exist during previous cycles. Mark-to-market accounting has two primary effects: accelerating the recognition of potential losses and potentially overstating those losses.

The ABX index (which tracks the performance of a basket of credit default swaps based on U.S. subprime home loans) is the basis for the marks. So far, the index has priced in losses of over 42% for subprime mortgages originated in 2007, which implies that over 70% of the loans will default eventually and the losses per default will be over 60%. Such an extreme level of losses will be hard to reach. While the defaults will happen over a long period of time, realized losses through May totaled only about 1.8%. However, mark-to-market accounting has resulted in companies recording the full loss in line with the ABX index up front instead of booking the losses as they emerge – which is what normal accrual accounting would dictate.

Lower Risk of Failure for Financials: The Facts

Beyond losses, the market doubts the very viability of these companies. There is a perception that value stocks generally, and financial stocks in particular, should trade at a discount to the market because they are more highly levered than the market and hence more likely to go bankrupt or suffer permanent capital destruction for equity investors. The speed with which Bear Stearns and some of the residential mortgage REITs collapsed in the past year provides fresh ammunition for this

Figure 1: Financials Less Prone to Failure
Average Business Failure Rate*
1989-2005



*80% decline in share price over three-year period
**Top 1,000 U.S. public companies by capitalization
***Cheapest quintile, ranked by price-to-book ratios
Excluding 2000: total universe, 1.6%; financials, 1.1%; value stocks, 1.0%; non-value stocks, 1.7%

Source: Compustat, Morgan Stanley, Pzena analysis

Figure 2: Average Cumulative Global Default Rates*
1970-2007

Retail & Distribution	19.6%
Media & Publishing	18.4%
Consumer Industries	16.0%
Capital Industries	14.9%
Transportation	11.7%
AVERAGE	*9.5%*
Energy & Environment	9.4%
Technology	9.3%
Financial, Insurance & Real Estate	3.8%
Banking	2.4%
Sovereign & Public Finance	2.2%
Utilities	1.5%

*Issuer-weighted; percent of all rated issuers in each industry group; 10th year after issuance

Source: Moody's, Pzena analysis

view. However, such fears about leverage and failure among the financials are not supported by the facts. We calculated the average rate of business failure for the 1,000 largest U.S. companies over the past two decades, a period including two recessions and credit cycles. We defined failure as an 80% decline in share price on a three-year trailing basis, sufficient evidence for permanent capital destruction. As you can see in Figure 1, the average rate of failure for financial stocks was half that for all the stocks as a group. Even leaving out the anomalous year 2000 when numerous internet stocks collapsed, the failure rate for financials was still lower.

Further, the long-term rate of failure for value stocks (defined as the cheapest quintile based on price-to-book value) was less than half that of the others – despite the fact that value stocks are often found in beaten-down industries and have higher leverage than the average.

The pattern seems to hold true on a global basis, based on default rates for corporate debt. Although equity investors can suffer serious value destruction without the company entering into bankruptcy, default rates are a good indicator of business failure. Figure 2 shows that financial companies are historically among the least likely to fail, in fact well below the average for all global industries.

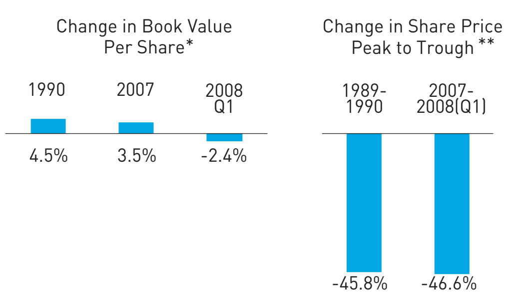
In spite of these factors, investors believe the combination of write-downs and dilutive equity offerings have permanently eroded the prospects for these businesses. This belief is based on the fact that worldwide financial companies have suffered accounting losses approaching $400 billion and have raised over $300 billion in capital. But again, the data tells a different story from what the emotion of the market might suggest. The decline in book value through Q1 has actually been minimal, and similar to what was experienced in the previous period of stress for the financial sector (1989-90). Figure 3 shows that aggregate book value per-share growth for financial companies remained positive in 2007, just as it did in 1990, and saw only a 2.4% drop in the first quarter of this year. Share prices have seen steep declines, of course, but already in excess of the early 1990s, and completely disconnected from the very slight decline in book value.

Future Earnings Power Is Intact

Since any equity investment boils down to owning a portion of a company's future profits, determining earnings power is crucial. The market believes that the level of financial firms' leverage in the future will be far lower than in the past, thereby reducing earnings power correspondingly. Does this claim hold up to scrutiny? Is there really a relationship between leverage and return for financials? We looked at return on tangible equity and tangible leverage ratios for U.S. commercial banks since 1970 (Figure 4). What we found was that over the past 36 years, financial firms' returns have actually been higher in years when their leverage was lower. The data not only contradicts the perception of a positive correlation between leverage and return, but rather supports a negative correlation.

It seems a simple paradigm. If you'd heard that all the oil producers had cut their output by 10%, it would be logical to assume that oil prices would rise and oil stocks would follow suit. Effectively, the banks have done the same thing: with the new capital discipline and reduction in leverage, they have less money to lend and spreads have risen sharply. Yet the stock prices haven't improved. As the more leveraged entities that accepted low spreads disappear, spreads (continued on page 12)

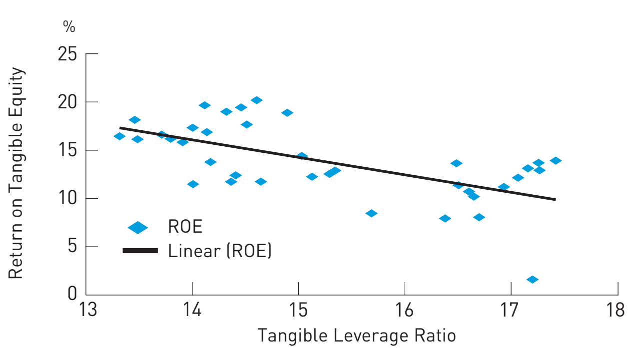
Figure 3: Financial Stocks Then and Now



* Financials in 1,500 largest U.S. companies by capitalization
** S&P Financial Sector Index

Source: Empirical Research, Bloomberg, Pzena analysis

Figure 4: Less Leverage = Higher Return
U.S. Commercial Bank Return vs. Leverage
1971-2007



Source: FDIC, Pzena analysis

for the industry are bound to remain higher in the future.

Finally, just as mark-to-market accounting can distort losses, it can also distort one's view of profitability. Reading the headlines suggests that financial companies' earnings were very weak in the latest quarter. But a closer look at the underlying cash earnings tells a different story. We looked at GAAP earnings and cash taxes paid for the 1,000 largest U.S. companies and found that for non-financials, the implied cash income was in line with income reported – but for financials, cash earnings exceeded GAAP earnings (Figure 5). Even leaving out the firms responsible for the biggest losses in the period, AIG, MBIA, and Citigroup, the pattern is the same. That makes sense: GAAP earnings reflect mark-to-market accounting (the front-loading of expected losses, which may or may not be real) and to a lesser degree, provisioning for future expected losses. For the average bank, the difference between GAAP earnings and cash earnings reflects an expectation of deterioration of credit. So GAAP earnings for financials have a forward-looking component and already bake in future losses.

Figure 5: Latest Quarter GAAP & Cash Earnings
(millions)

	Cash Tax Paid	GAAP Reported Net Income	Cash income Implied @35% tax rate
Financials	$4,524	$(2,136)	$12,926
Ex AIG, MBIA & Citi	$5,739	$13,186	$16,396
Non-Financial	$27,128	$76,748	$77,509

Note: Of the 1000 largest U.S. companies by market cap, 348 non-financials and 119 financials report quarterly cash tax paid

Source: Factset, Pzena Analysis

In Conclusion

The market's panic over the impact of mark-to-market accounting on financial companies' earnings has created an extreme valuation opportunity. Further, this obsession with current news has caused most investors to disregard the data that actually drive these companies' long-term earnings prospects. Of course, not every financial company is going to come through this period intact. Some of the losers have already fallen and others are likely to follow. However, these are exactly the times when serious research and valuation discipline can add significant value. We believe that world-class franchises like Citigroup, Royal Bank of Scotland, HSBC, and others are being offered at fire-sale prices relative to their long-term normal earnings power. The timing of the turn, as always, is uncertain. But the opportunity is greatest when unquantified fear is at its peak. ■

Disclosures

Past performance is no guarantee of future results. The historical returns of the specific portfolio securities mentioned in this commentary are not necessarily indicative of their future performance or the performance of any of our current or future investment strategies. The investment return and principal value of an investment will fluctuate over time.

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